The Economist

JUNE 14TH–20TH 2008

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Print Edition June 14th 2008

Iraq starts to fix itself
The gains are fragile, but Iraq is doing a lot better than it was only a few months ago: leader

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Politics this week

Jun 12th 2008
From The Economist print edition

Getty Images

Hillary Clinton formally suspended her campaign for the Democratic nomination in a graceful speech in which she urged all her supporters to work hard to ensure the election of Barack Obama as the next president. Her rival promptly posted a big “Thank you Hillary” banner on his website. All looked harmonious, for now. See article

Mr Obama kicked off his next campaign, the one against John McCain, with a tough speech on the economy in which he accused his Republican rival of pursuing a continuation of George Bush's policies. Mr McCain hit back, describing his rival as a typical tax-and-spend Democrat. See article

George Bush started a tour of Europe that is expected to be his last as president. He was greeted with little fanfare in each of the capital cities on his itinerary. He reiterated his desire to use diplomatic means to stop Iran from getting a nuclear bomb and said that new sanctions might be needed. But, he added, “all options are on the table,” presumably including force. See article

Tornadoes and severe **flooding** struck cities in several mid-Western states, including Iowa, Indiana and Minnesota. At least 15 people died.

Soft speaking and big sticks

Exactly a year after the Islamist **Palestinian** movement, Hamas, took over the Gaza Strip, **Israel's** government said it would continue to back efforts by Egypt to reach a truce with it but told the army to prepare for military action if mediation failed. Meanwhile, the Palestinian prime minister, whose writ runs only on the West Bank, said he did not believe there would be a peace deal with Israel this year, as George Bush has predicted.

Morgan Tsvangirai, who is challenging Robert Mugabe, **Zimbabwe's** president, in an election on June 27th, said the country “is effectively being run by a military junta” and that 3,000 of his supporters have needed hospital treatment because of state-organised violence. Tendai Biti, the secretary-general of Mr Tsvangirai's party, the Movement for Democratic Change, was arrested at Harare Airport.

The government of **Djibouti** claimed that nine of the statelet's troops had been killed in border clashes with **Eritrean** soldiers. The fighting started after weeks of rising tension between the two neighbours in the Horn of Africa.

An airliner burst into flames after landing in bad weather at the airport outside Khartoum, **Sudan's** capital, killing at least 29 people.

The hardest word

Canada's government apologised formally for the first time for forcing 150,000 aboriginal children to attend church-run boarding schools in an attempt to assimilate them into white society. See article

AFP

Hugo Chávez, **Venezuela's** leftist president, called on Colombia's FARC guerrillas to end their four-decade armed struggle and release around 700 hostages. Computer files seized during a recent raid on a rebel camp had appeared to confirm Venezuela's backing for the guerrillas. See article

Boosted by a construction boom and high world food prices, **Brazil**'s economy grew at an annual rate of 5.8% in the first quarter. But such hectic growth is

unlikely to last.

Thawing straits

China and **Taiwan** resumed formal talks for the first time since 1999. Meeting in Beijing, the two sides were expected to reach agreements allowing the first regular direct passenger flights, and visits by Chinese tourists to Taiwan. See article

South Korea's prime minister, all 15 cabinet members and nine senior presidential aides tendered their resignations as demonstrations gathered strength in Seoul against the government's decision to lift a ban on importing American beef. The president, Lee Myung-bak, was expected to accept five or six of the ministerial resignations. See article

The upper house of **Japan**'s parliament, the Diet, passed a censure motion against the serving prime minister, Yasuo Fukuda. It was the first such motion in Japan's history, but carries no legal weight. See article

Afghanistan's foreign donors gathered in Paris to consider the government's request for $50 billion to finance a five-year reconstruction plan.

An air raid by American forces based in Afghanistan killed at least 11 Pakistani paramilitaries and eight Taliban militants in the tribal areas of **Pakistan**. A spokesman for the Pakistani army described the attack as an act of aggression that hit at the very basis of co-operation in the “war against terror”. See article

Lawyers from across Pakistan took part in a protest march to **Islamabad** to demand the reinstatement of senior judges sacked by President Pervez Musharraf under emergency rule last year. The coalition government is divided over how to handle the demand.

Sheikh Hasina Wajed, a former prime minister of **Bangladesh** and leader of one of the two main political parties, the Awami League, was freed from jail on bail to allow her to receive medical treatment abroad. She had been detained on corruption charges. The League had made her release a condition of taking part in elections in December.

Fuming

EPA

Protests over the rising **price of fuel** spread across Europe. Fishermen went on strike in Belgium, France, Italy and Portugal. Two lorry drivers were killed during fuel protests in Spain and Portugal. See article

As *The Economist* went to press, **Ireland** voted in a referendum on the Lisbon treaty. Ireland is the only one of the 27 European Union members to hold a referendum on the new treaty. Our analysis of the results will appear on www.economist.com.

Stojan Zupljanin, a **Bosnian Serb** wartime commander, was arrested in Serbia and will be sent to The Hague's war-crimes tribunal. He was one of four fugitive Serbs wanted by The Hague and still at large.

Britain's beleaguered prime minister, Gordon Brown, narrowly won a parliamentary vote to extend to 42 days the period for which the police may hold suspected terrorists without charging them. See article

The day after Mr Brown's victory, David Davis, the Conservative shadow home secretary, announced his surprise resignation. Mr Davis quit to protest what he described as the growth of government surveillance and the erosion of Britain's civil liberties. See article

Business this week

Jun 12th 2008
From The Economist print edition

The fear of **inflation** spooked markets. In America government-bond yields moved sharply higher; yields also rose in Europe and Japan. Tough talk from the Federal Reserve and the European Central Bank sparked the shift. Futures markets now expect American and euro-area interest rates to rise before the end of the year. The Bank of Canada kept its rates on hold, confounding widespread expectations of a cut. See article

Fear of rising prices is especially acute in **emerging markets**. The benchmark Shanghai Composite index endured its biggest one-day drop for a year, after China's central bank told banks to set aside more money in reserves in a bid to curb inflation. India's central bank raised interest rates for the first time in 15 months, Vietnam's for the third time this year.

A massive one-day surge in the **oil price**, to a new record of $139 a barrel, fuelled the anti-inflation rhetoric. Prices later dropped back, but not by much. The average price of petrol in America hit $4 a gallon for the first time.

Capital fetters

Lehman Brothers, the smallest of the Wall Street investment banks, sought to allay fears about the weakness of its balance sheet by raising $6 billion of new capital. Its shares still fell, on news that it had suffered a loss of $2.8 billion in the second quarter, thanks mainly to further declines in the value of its mortgage-related assets.

Capital-raising also preoccupied **British banks**. Royal Bank of Scotland successfully completed its mammoth £12 billion ($24 billion) rights issue. HBOS, the country's biggest mortgage lender, sweated as its share price dipped below the discounted price of its own £4 billion rights issue. Speculation swirled about Barclays' need for capital.

BNP Paribas strengthened its presence in America. The French bank agreed to buy the **prime-brokerage** unit of Bank of America, which is pruning its investment-banking activities. The price was put at $300m.

Shares in **Babcock & Brown**, an Australian securities firm, lost almost 30% of their value in a day, as investors fretted about its levels of indebtedness. The company, which buys infrastructure assets and puts them into funds that it then manages, blamed short-sellers for its woes.

Second bite

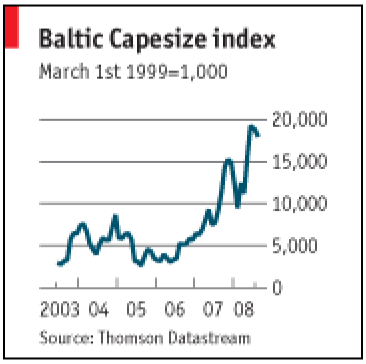
Apple unveiled an upgrade of the **iPhone**, complete with faster internet access and location-tracking technology. More important were changes to the company's business model. Mobile-phone operators will subsidise the cost of the new iPhone, sending the price of the handset sharply down. Operators will make their money on usage fees. See article

African stockmarkets rang up two big initial public offerings. In East Africa's biggest-ever IPO, Safaricom, a Kenyan mobile-phone operator part-owned by Vodafone, made its entrance on the Nairobi stock exchange. Shares in the company rose by more than 50% in their first day of trading. Celtel Zambia, another mobile-phone company, floated 20% of its shares on the Lusaka exchange.

Staples, a stationery retailer, agreed to buy Corporate Express, a Dutch firm, for $2.6 billion. The deal makes Staples the world's largest direct distributor of office supplies to companies.

Freight expectations

The Baltic Capesize index, which measures the cost of chartering **huge ocean-going vessels** used to transport iron ore and coal, briefly hit record highs. Surging demand for raw materials in emerging markets has been reinforced by the earthquake that struck China in May. Not only does China need materials to carry out rebuilding work, but it also needs shipping to help bypass shattered transport infrastructure.



InBev, the world's biggest brewer by sales, put forward an unsolicited $46.3 billion cash offer for **Anheuser-Busch**, the maker of Budweiser beer. A deal would open the door to the vast American market for InBev, which owns premium brands such as Stella Artois and Beck's. See article

Foster's, an Australian drinks group, unveiled a profits warning and announced a strategic review of its sickly wine businesses. Its American sales have been hit by the appreciation of the Australian dollar and surplus production. Trevor O'Hoy, the chief executive, carried the can and quit.

Relations between BP and its partners in its Russian joint venture further soured. The Russian billionaires who own **TNK-BP** along with the British oil company announced that they plan to sue for greater control of the venture, which accounts for one-quarter of BP's oil production and 40% of its replacement reserves.

KAL's cartoon

Jun 12th 2008
From The Economist print edition

Illustration by Kevin Kallaugher

Economist.com OPINION LEADERS

Iraq

Iraq starts to fix itself

Jun 12th 2008
From The Economist print edition

Its people are still suffering monstrously, but Iraq is doing far better than it was only a few months ago

Eyevine

AFTER all the blood and blunders, people are right to be sceptical when good news is announced from Iraq. Yet it is now plain that over the past several months, while Americans have been distracted by their presidential primaries, many things in Iraq have at long last started to go right.

This improvement goes beyond the fall in killing that followed General David Petraeus's “surge”. Iraq's government has gained in stature and confidence. Thanks to soaring oil prices it is flush with money. It is standing up to Iraq's assorted militias and asserting its independence from both America and Iran. The overlapping wars—Sunni against American, Sunni against Shia and Shia against Shia—that harrowed Iraq after the invasion of 2003 have abated. The country no longer looks in imminent danger of flying apart or falling into everlasting anarchy. In September 2007 this newspaper supported the surge not because we had faith in Iraq but only in the desperate hope that the surge might stop what was already a bloodbath from becoming even worse (see article). The situation now is different: Iraq is still a mess, but something approaching a normal future for its people is beginning to look achievable.

The guns begin to fall silent

As General Petraeus himself admits, and our briefing this week argues, the change is fragile, and reversible (see article). But it is real. Only a few months ago, Iraq was in the grip not only of a fierce anti-American insurgency but also of a dense tangle of sectarian wars, which America seemed powerless to stop. Those who thought it was just making matters worse by staying on could point to the bloody facts on the ground as evidence. But now it is time to look again. Each of those overlapping conflicts has lately begun to peter out.

A few Sunnis, motivated by Islam or simple resentment of foreign military occupation, continue to attack American forces. But many Sunni tribes, repelled by the atrocities committed by their former and often foreign allies in al-Qaeda, have joined the so-called Sunni awakening, the *Sahwa*, and crossed over to America's side. At the same time, Sunnis and Shias have stopped killing each other in the vast numbers that followed the blowing up of a Shia shrine in early 2006. General Petraeus's surge is only one reason for this. Another reason, less flattering to the Americans, is that after last year's frenzied ethnic cleansing fewer neighbourhoods are still mixed. But it is also the case that a lot of Iraqis, having waded briefly into the horror of indiscriminate sectarian slaughter, have for the present made a conscious decision to step back.

The conflict between Shias and Shias has died down too. In the past few weeks Iraq's prime minister, Nuri al-Maliki, has belied a reputation for weakness by sending the army to take control of the port city of Basra and the Baghdad slum known as Sadr City, both strongholds until then of the powerful militia run by Muqtada al-Sadr, a vehemently anti-American Shia cleric. The fact that Mr Sadr considered it wise not to resist suggests not only that the army is now strong enough to out-face private militias but also that the state has acquired far greater political legitimacy, in Shia minds at least.

Needless to say, these conflicts could resume. The Sunnis fighting on America's side today could direct their fire back towards the Americans and Shias tomorrow if not enough room is made for them in the new, Shia-dominated order. On the Shia side, it is not clear whether Mr Sadr has given up violence for good. And his is not the only political movement to have a private army. Sunnis, Shias and Kurds alike still see their respective militias as a hedge against an uncertain future.

To that extent, Iraq is still far from normality. But if the calm survives, politics will at least have a chance. Mr Maliki's next job is therefore to go ahead with the provincial elections due before the end of the year. A good showing by the Sunnis, too few of whom voted in 2005, could bring them back into the political mainstream, enabling them to wield serious power in their own provinces at least. The elections can also provide a useful alternative path to power for the Sadrists, if they really have given up violence and decide to take part.

George Bush meanwhile has a further part to play, which consists mainly of not doing things that might tempt him. He should not, for example, attack Iran. One of the impressive things about Iraq's present government is its refusal to take sides between America and its next-door neighbour. It needs good relations with both if it is to prosper. Mr Bush has also to find a way to leave to his successor the business of negotiating a new agreement on the status of American forces in Iraq. This may become a toxic issue in Iraq's elections as the existing UN mandate expires. Mr Maliki is said to want a guarantee that America will defend its borders. His opponents accuse America of seeking permanent bases in Iraq, turning it into a vassal. It would be wrong for a lame duck in Washington to tie the hands of the next administration on such matters.

It's really not about that any more

In highlighting the improved conditions in Iraq we do not mean to justify *The Economist*'s support of the invasion of 2003 (see article). Too many lives have been shattered for that. History will still record that the invasion and occupation have been a debacle. Iraqis even now live under daily threat of violent death: hundreds are killed each month. They remain woefully short of the necessities of life, such as jobs, clean water and electricity. Iraq's government is gaining confidence faster than competence. It is still fractious, and in many places corrupt.

Nor does it follow that a turn for the better necessarily validates John McCain's insistence on America staying indefinitely. A safer Iraq might make Barack Obama's plan to pull out most American troops within 16 months more feasible, though at the moment a precipitate withdrawal looks foolish. But to guard the fragile improvements, the key for America must be flexibility. Both candidates have to keep their options open. If America's next president gets Iraq wrong because he has boxed himself in during the campaign, all the recent gains may be squandered and Iraq will slide swiftly back into misery and despair. That would be to fail twice over.

Colombia

The end of illusion and the last guerrilla

Jun 12th 2008
From The Economist print edition

A war may be ending in Latin America. But fixing the peace terms will be hard

Eyevine

SIX years ago, Colombians elected Álvaro Uribe as president because he pledged to beef up the security forces to defend a democracy under murderous assault from left-wing guerrillas and right-wing paramilitaries. Many well-meaning people in the United States, Europe and Latin America wailed that Mr Uribe was a warmonger, and urged him instead to reach a "political solution" with the guerrillas. Military victory against the FARC, the oldest, biggest and wealthiest guerrilla army in Latin America, was impossible, they declared.

Well, it now looks possible. Over the past few months the FARC has suffered a series of devastating blows. It has lost three of the seven members of its ruling secretariat, including Manuel Marulanda, the FARC's 78-year-old founder and undisputed leader, who died of a supposed heart attack. Thousands of fighters have deserted.

Even Hugo Chávez, Venezuela's leftist president, who recently called for the world to recognise the FARC as "legitimate belligerents", has changed his tune. This week he urged the FARC and its new leader, Alfonso Cano, to end the war and release their 700-or-so hostages. "At this moment in Latin America an armed guerrilla movement is out of place," Mr Chávez said. Leave aside that Mr Chávez's statement may have been prompted by evidence that seems to tie Venezuela to the guerrillas (see article). Whatever the motive, it is to be hoped that Mr Cano concurs. But what if he doesn't?

Fighting the FARC and seeking a peace deal have never been alternatives. Mr Uribe's predecessor spent three years in fruitless talks, during which the guerrillas made it clear that their aim was to impose communism, making demands for political and socio-economic changes that no democracy could accept, even as they carried on killing and kidnapping. Weakening the FARC militarily has thus always been a necessary condition for achieving a political settlement.

Now that the guerrillas have been reduced, what could Mr Uribe reasonably offer them? Here there is a difficulty. When the right-wing paramilitaries showed interest in a political solution, agreeing to demobilise in return for lenient treatment of their crimes, many of those well-meaning outsiders promptly excoriated Mr Uribe for offering a sweetheart deal to drug-trafficking mass-murderers. Colombia's Supreme Court took a similar view. It put teeth into the law under which the paramilitaries disarmed, requiring them to give a full account of their crimes. But some of the warlords continued to run their criminal rackets while in jail. Last month Mr Uribe extradited 14 of them to the United States, where they face life in prison.

The tough line Colombia has taken with the right-wing warlords makes a peace deal with their left-wing

counterparts harder. The FARC's leaders, too, have committed crimes against humanity, and some of them traffic drugs. So they now have little incentive to demobilise. Some Colombians say the best place for the FARC's leaders is jail. That is true, but the best can be the enemy of the good. Though the FARC can no longer destroy Colombia's democracy, fighting to the last guerrilla is in nobody's interest. Ending this conflict will require compromise as well as continued military firmness.

Forgiveness maybe, but no reward

Getting the compromise right will be difficult. It will almost certainly have to include security guarantees for the FARC's leaders. But it should not, as some say, include any offer of power-sharing. Colombia is a democracy. In return for laying down their arms and ending a pointless and destructive war, FARC soldiers should be encouraged to take part in politics, but on exactly the same terms as any other Colombian.

Economist.com OPINION LEADERS

Turkey

A tragedy in the making

Jun 12th 2008
From The Economist print edition

The likelihood of a ban on the ruling party is growing. It would be a disastrous mistake

Reuters

TURKEY'S staunch secularists have been uneasy ever since the Justice and Development Party (AKP) swept to power in 2002. The AKP has its roots in two overtly Islamist parties that were previously banned for anti-secularism. So it is not, at first sight, surprising that the constitutional court should be considering a similar ban on the AKP, and on 71 named individuals, including the president, Abdullah Gul, and the prime minister, Recep Tayyip Erdogan.

Yet to ban the party, and to bar its leaders from politics for five years, less than 12 months after the AKP won re-election with 47% of the vote, would be to drop a bomb on Turkey's fragile democracy. Unfortunately, the court's latest ruling, overturning a law to permit women to wear the Islamic-style headscarf at universities, makes it likely that it will indeed ban the AKP. The headscarf law is central to the chief prosecutor's case. By voting 9-2 to annul it, the court is hinting heavily that it will endorse the prosecutor's main claim that the AKP is “the focal point of anti-secular activities” (see article).

There is nothing misguided about secularism, a cornerstone of Kemal Ataturk's republic since 1923. Nor is it wrong in principle for a court to decide that a law, or even a political party, is unconstitutional. But Turkish secularism can be overly fundamentalist, implying not just a healthy separation of church and state but total control of religion by the state. As for the constitutional court, it has a spotty, partisan record and a history of banning political parties, not always with good reason. Some 24 parties have been banned in Turkey since 1961 (against only three in western Europe since 1950). And in 23 of these cases, the European Court of Human Rights has ruled that the ban violates its charter of human rights.

The Turkish prosecutor insists that the European court will not take this view in the case of the AKP. Yet his charge sheet is long on assertions and short on hard facts. He cites newspaper articles and interviews to justify an otherwise unsubstantiated claim that the party is employing “dissimulation” to bring in *sharia* law. That is not good enough. Not only do Mr Erdogan and the AKP insist vehemently that they uphold the secular state; they are also supported by a six-year record of economic and political reform, more rights for minorities and women, and the start of membership talks with the European Union. The AKP government has, in short, been both more liberal and more successful than any secular predecessor.

Don't do it

That ought to be enough to persuade the judges to be cautious, even at this late stage. It is, after all, one thing to find a specific law unconstitutional. But it is quite another to ban an entire political party and

its leaders so soon after they have been massively endorsed by voters. In any democracy, this would be hugely problematic—so the bar for such a decision should be set exceptionally high.

The fallout at home would be serious, even if the AKP were reconstituted in a different form. It is now the only party with seats all over the country; its secular opponents are almost entirely unrepresented in the east and south-east. The AKP stands firmly for a growing middle class of conservative (and pious) Turks in Anatolia, and increasingly for Turkey's Kurds as well. The secular parties speak largely for a shrinking elite that has understandable but excessive fears of a rising Islamic fundamentalism turning Turkey into a new Iran. A ban on the AKP would create huge tensions in a country that is anyway edgy—and whose economy is already teetering.

A constitutional crisis in Turkey would have grave international repercussions, too. It is hard to see how the EU could continue membership talks with a country that had banned its biggest party and its leaders. Opponents of Turkish membership would leap at the chance to stop the talks starting again. Renewed restiveness among Kurds could spill into northern Iraq: some Turkish generals say they would like to expand operations against Kurdish terrorists based there. And a crisis in Turkey would surely halt the hesitant first steps being taken towards settling the Cyprus dispute.

A better course would be for all parties to work together to revise Turkey's constitution, which was written soon after a military coup in 1980, and which both the EU and most Turks believe needs modernisation. Mr Erdogan can rightly be blamed for displaying an autocratic streak, for failing to engage his opponents and for not pursuing constitutional reform urgently enough since his re-election last July. But it would serve nobody's interest to ban him and his party.

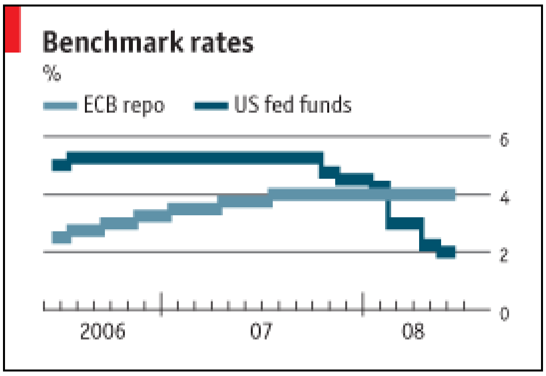
Economist.com OPINION LEADERS

The Federal Reserve and the European Central Bank

Hawk alert

Jun 12th 2008
From The Economist print edition

Central bankers are talking tough. They may be talking themselves into trouble



YOU can hear the talons scratching. Ben Bernanke, chairman of the Federal Reserve, first adopted a hawkish tone on June 3rd, lamenting the weak dollar's part in an "unwelcome" rise in inflation. Two days later Jean-Claude Trichet, president of the European Central Bank, stunned financial markets by declaring that the ECB may raise short-term rates at its next meeting in July. Then Mr Bernanke swooped once more. In a speech on June 9th he played down the news that America's jobless rate had risen in May by half a percentage point, to 5.5%. He argued that the risk of a nasty economic downturn had fallen and he promised that the Fed would "strongly resist" any rise in people's expectations of future inflation. As central banks from Canada and Britain to Vietnam and India have shown their claws, bond markets have been in turmoil (see article). Investors have concluded that short-term interest rates are heading up, and fast.

About time too, you might say. With falling odds of a financial-market catastrophe and inflation uncomfortably high (and set to rise higher) the balance of risks is shifting. If central bankers have learnt anything over the past three decades, it is to make sure that people do not start to think long-term inflation rates will creep up. Words—including a certain anti-inflationary swagger—are valuable weapons in the modern central banker's arsenal.

All that is true. But talk soon loses its power to convince unless people believe it will be backed up with action. The problem today is that the distance between talk and action differs dramatically between the Fed and the ECB.

Birds of a feather

Granted, the two central banks survey different economic and monetary landscapes. America is close to recession and real short-term interest rates are negative. The euro zone has a stronger economy but much tighter monetary conditions (the ECB has kept short-term rates unchanged at 4% throughout the credit crisis). Both central banks face a similar problem: how to deal with inflation that is being pushed up by commodity prices, particularly for oil. Both are determined to avoid the mistakes of the 1970s, when loose monetary policy transmitted the oil shock into the economy, setting off a spiral of rising wages and prices. But the central banks disagree as to the amount of insurance they need to stop that happening.

The European Central Bank reckons that a slower economy will not be enough to stop prices rising. Although output has been surprisingly resilient so far, most forecasters expect a slowdown in the second half of the year. But with unemployment low and headline inflation high, the ECB—with its single mission to keep inflation at or below 2%—is worried about knock-on effects. Even though oil is the main culprit and long-term inflation expectations have not moved much, the ECB's desire to pre-empt persistent inflation points clearly to higher interest rates in July.

The Fed seems much less likely to raise rates. Despite some warning signs—on one measure, for instance, consumers' expectations for long-term inflation are at a 12-year high—wage growth is slowing, and average pay cheques are falling sharply in real terms. There is no whisper of a wage-price spiral. What is more, house prices are still tumbling and the financial hangover from the credit crunch is not over yet. The risks to growth, as Mr Bernanke admits, are on the "downside". And, for better or worse, the Fed is charged with caring about both full employment and stable prices. Add in the politics of raising

interest rates just before a presidential election, and the odds are that the Fed's talk remains just that.

A wide transatlantic gap between rhetoric and action is unfortunate—and bodes ill for the Fed's credibility. After the Fed's rapid, pre-emptive loosening to a federal funds rate of 2%, financial markets will be watching to see whether it is correspondingly prepared to tighten again. Mr Bernanke has made his job all the harder by adding the dollar to the mix. If the ECB tightens and the Fed does not, the dollar is likely to weaken against the euro—exactly the opposite of what Mr Bernanke last week implied he wished to happen. For the time being, the dollar is up and oil prices down. The hawkish rhetoric seems to be working a treat. But unlike real talons, mere words will not leave a lasting mark.

Economist.com OPINION LEADERS

Executive pay

Let the fight begin

Jun 12th 2008
From The Economist print edition

Give shareholders a vote on pay; but don't let others interfere

Illustration by David Simonds

“OBSCENE”, “bizarre”, “a scourge”: Europe's politicians are in no doubt that bosses' high pay is a scandal. If they are right, the continent's companies are in grave danger. Executive pay is not only a measure of what society judges as fair; it is also a test of whether a business is run for its shareholders. If a board can motivate managers, it will get the best out of them. If it cannot stand up to the chief executive and his cronies over their pay, then it will struggle to control them when they want to buy this dud rival or diversify into that dead-end business.

But are the politicians right? They have caught the mood in equality-conscious Europe, where the millions earned by some are stirring up resentment. Politicians in the Netherlands, France and Germany are squaring up to bosses over pay (see article). America is joining in. John McCain, the presumed Republican presidential nominee, this week complained that failed senior managers at big firms are “packed off with $40m or $50m for the road”.

It is easy to find executives who look undeserving—or worse. The head of ABN AMRO, a Dutch bank, won a €26m ($40m) pay-off when his poorly performing bank was bought by a rival. Chuck Prince, of Citigroup, and Stan O'Neal, of Merrill Lynch, walked off with far more, even as the banks they left behind were on their knees. And tens of millions were paid by friendly boards to Richard Grasso at the New York Stock Exchange and Ray Irani at Occidental Petroleum.

It is far harder to show that managers in general are overpaid. At companies owned by private equity, the board and the shareholders are one and the same: their directors are hardly under the thumb of managers. But they still believe managers make enough difference in a company to spend money on hiring the best ones. Indeed, they are willing to pay successful bosses several times more than listed firms do. And the same goes for partnerships: witness lawyers' big salaries.

Managers' pay has grown faster than workers' pay, but the reasons for this are not sinister. Whereas workers' pay depends on the labour market (and has been kept down by the huge numbers of people joining the global economy), managers' bonuses are chiefly tied to returns on capital. Boards introduced stock options and hurdles because investors wanted executives to worry about profits. Profits have recently been good, so pay has been high. Similarly, as the assets inside companies grow, you would expect them to pay more in the market for talent. Even though Cristiano Ronaldo is no more gifted than Pele was, he is paid vastly more. Football clubs have used the extra money from TV rights to bid up players' wages. Bigger firms will bid up the pay of the most senior managers.

Governance in Europe is not perfect. As family and bank capitalism has retreated, so ownership has become more fragmented—making boards harder for shareholders to control. But European boards are not timorous. A recent survey by Booz & Company, a consultancy, found that European bosses were more likely to have left than American ones—and that they tended to last less time in the job. European boards have generally done more than American boards to link pay to performance. And pay, though lower, has broadly tracked the increases in America over the past few decades even as monitoring by shareholders has improved. That is not what you would expect if poor governance were behind the bonanza.

Pay on display

Pay is complex. In different circumstances and different industries firms will rightly choose different packages. Even severance pay may have its place, if it helps engineer a change of control. So politicians should reject laws about pay, which are too sweeping to be useful. Legislation and demagoguery will only drive managers away from listed companies and make pay packages even more complex—and so harder to monitor.

At the same time, boards will sometimes make mistakes and fall victim to overmighty bosses. Hence politicians need to insist that shareholders can hold the board to account through a vote on pay—as, indeed, they can in many countries. That will not lead to peace over pay. But how could it do so when shareholders sometimes need to crack the whip?

Economist.com OPINION LETTERS

On international banking, text-messaging, European corruption, Thailand and the Philippines, distances in America

Jun 12th 2008
From The Economist print edition

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Explaining the credit crunch

SIR – Your otherwise excellent special report on international banking (May 17th) perpetuated a myth that should surely by this time have been firmly put to rest. If a house price or an equity price falls there is a genuine loss in economic value, at least over the time period concerned. If a derivative contract is entered into between two parties based on the house or equity price (or anything else, such as the value of a credit instrument like a loan or mortgage) the change in value of the underlying asset will generally give rise to a profit for one party and an equal and opposite loss for the other (leaving aside second-order effects).

Overall, economic value is neither created nor destroyed, it is just redistributed. To describe credit derivatives as an "amplifier" of the credit crisis is, therefore, simply wrong. Certainly credit derivatives change the distribution of gains and losses, but they do not amplify them. The sheer size of the credit-derivatives market and problems with settlements within it may give rise to genuine concerns, but this is not one of its faults.

John Hawkins
Principal
Mercer
London

SIR – Successive psychological studies have shown that due to evolutionary factors humans are risk-averse, that is, we naturally prefer to take a small profit than to risk a bigger loss, however great the potential upside. This means high-risk speculation and subsequent bubbles should normally occur only at the margins among those who are either very greedy or can afford the loss. The recent rampant speculation in everything from property to foodstuffs is thus unnatural rather than instinctive. So why has there been such widespread risk-taking?

In recent years central banks could have kept rates slightly higher, thereby preventing the current debacle. It isn't rocket science. You can regulate all you like and set up any number of risk-management committees, but if you have dangerously low or negative after-tax real interest rates, people have no choice but to borrow or to find yet more innovative and complex ways to speculate. Investors simply have no choice.

We want to get out of this mess and create a sustainable financial model and a society where people have the option of saving their money, instead of wildly speculating or spending. We need banks to target after-tax real interest rates. That will mean a painful readjustment, but ultimately a more sustainable and rational approach to money.

Andrew Hunt
Edinburgh

SIR – I am perplexed at your continued tolerant attitude towards the banking sector. The recent decision by governments to bail out these institutions suggests that in reality they are little more than glorified utilities. Governments create money, a commodity that everyone needs, and the banks exist to allocate it in the most efficient way. How would you have responded if water utilities had delivered toxic products to their customers while the management drew huge salaries?

Chris Bale
Ness, Cheshire

Textpert advice

SIR –"Text-messaging corrupts all languages," you say in your article on text-messaging in France ("Parlez-vous SMS?", May 24th). I can imagine the French believing this, but the studies on SMS that have been done over the past five years show quite the opposite. I recently researched the field and the results are clear.

Text messages do not use as many abbreviations as people think: typically less than 10% of the words in a text will be abbreviated. These abbreviations are not new, but have been around in some cases for hundreds of years. Rebuses such as C for "see" and U for "you" were common in Victorian times. Furthermore, huge numbers of texts these days are sent by adults (the oldest person I know who texts is an 86-year-old grandmother), and by institutions ranging from the BBC to the stockmarket. In institutional texts, standard English is the norm, and abbreviations are often disallowed.

Text-messaging gives children a motivating opportunity to practise reading and writing, to improve their skills in economy of expression, and to play with the sounds and spellings of the language in imaginative ways. Not surprising, then, that studies are beginning to show that the more you text, the better your literacy scores will be. Even the French will discover this, in due course.

David Crystal
Holyhead, Anglesey

SIR – It is possible that Marcel Duchamp anticipated the French texting trend in 1919 with his famous postcard of the Mona Lisa. As well as adorning her with a moustache and goatee, he wrote the letters LHOOQ underneath. Phonetically, this is *elle a chaud au cul*, which might be liberally translated as "she's a bit of a goer."

Roger Gill
Cradley, Herefordshire

The price of progress

SIR – Regarding corruption in central and eastern Europe ("Talking of virtue, counting the spoons," May 24th), wait for the next few steps in the European Union's enlargement! When it comes to graft, Croatia is no slouch. But then come Bosnia, Montenegro, Serbia, Macedonia and Albania, all of which are close to the tail of Transparency International's corruption-perceptions index. The problem is not only the politicians and administrators; rather, corruption has been in the very mindset of all and sundry in these countries for untold generations. Living for centuries on the fringes of Turkey, Italy, Austria and Hungary, these subjugated peoples learned to bribe their way to everything outside their reach.

Ranko Bon
Motovun, Croatia

Hands across the water

SIR – Thailand, you say, "risks becoming one of those perennially unstable, tragi-comic countries, such as the Philippines, which the outside world overlooks" ("Protests and coup rumours return", May 31st). Is this really a fair comparison? The Philippines is a functioning democracy, despite the tragi-comic coup attempt by a few junior officers a few months ago. Its population is educated and globalised. Thailand has had 19 coups since 1932. Thais remain relatively poorly educated and don't venture abroad very often. Joking about the king in Thailand can lead to jail; in the Philippines, a joke about the president can become a popular ringtone.

Neil Alexander
Vancouver

Shaggy-dog story

SIR – In "fly-over" America, we are used to geography errors. But whatever the media-relations folks in

Branson, Missouri may have told you, it is not “reachable within a day's drive by half of the country's population” (“Come to the ark”, May 24th). In a very long day and by spending too long behind the wheel, from Atlanta, Chicago, Dallas or Houston. But certainly not from any of America's east- or west-coast cities.

Charles Clark
Prairie Village, Kansas

Economist.com WORLD MIDDLE EAST & AFRICA

The change in Iraq

Is it turning the corner?

Jun 12th 2008 | BAGHDAD AND ERBIL
From The Economist print edition

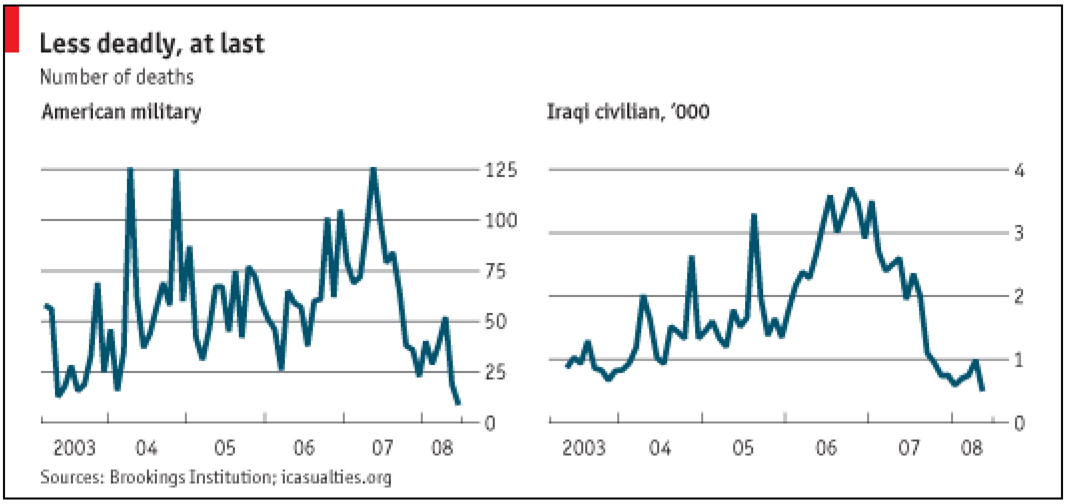
By all the main measures—military, political and economic—Iraq is now improving, from a dire base. But that does not yet mean it is headed for peace and prosperity

Eyevine

THOUGH still lacerated by the tragedy of the past five years, Iraq is at last getting better all round. The violence, albeit still ferocious in parts of the country, has subsided dramatically. The American military "surge" that began a year ago has worked better than even the optimists had hoped, helped by ceasefires with Shia militias, by accords with Sunni tribal leaders and by the fact that sectarian cleansing in many areas is sadly complete.

Politics is also beginning to stutter towards something approaching normality, with signs of an accommodation between the three main communities—Shia Arabs, Sunni Arabs and Kurds—and the prospect of a series of vital laws, on such matters as sharing the revenue from oil, being passed, though they are still subject to endless last-minute hiccups. Some key laws, for instance on pensions and the budget, have recently been enacted. A set of provincial elections towards the end of this year has a chance of empowering the aggrieved Sunni Arabs. Various Sunni ministers who walked out of the government a year ago in a huff may soon be back in.

The economy has begun to grow fast too, though its ripples have yet to be felt across the country. The soaring price of oil, along with a mild improvement in production to just above its pre-war peak, mean that the government has more cash to spend than it is has had since the first Gulf war of 1991.



In sum, the worst of the horrors unleashed in the sectarian violence after the bombing of a Shia shrine in February 2006 may be over. The death rate is sharply down. Fewer Americans were killed in hostilities in May, when 19 died, than in any month since the invasion of March 2003 (see chart). That is half the average for the first four months of this year and one-quarter of last year's rate. The Iraqi civilian toll is harder to measure. Iraq Body Count, a group that collates a tally of casualties from media reports, noted 752 civilian and police deaths in May, a grim figure but less than a third of the average last summer.

American officials in Baghdad are careful to avoid the misplaced triumphalism expressed immediately after the invasion five years ago. Progress, as General David Petraeus, the American commander on the ground, is wont to say, is "fragile and reversible". But in Baghdad's Green Zone, the sealed-off sanctuary on the west bank of the River Tigris where the American-led coalition's headquarters and most of Iraqi ministries are ensconced, optimism is back in the air, reflecting a broader change of mood in the country. An opinion poll in February that asked Iraqis "How would you say things are going overall these days?" found that 43% said they were going well, up from only 22% in September. Among Shias, the figure rose from 39% to 61%; among Sunnis, it went from a paltry 2% to 16%, but a notable jump all the same. If the poll were conducted today, the answers would be more positive still.

One clear reason for hope is that al-Qaeda's Iraqi branch has taken a big knock. The CIA's director, Michael Hayden, recently said it had suffered a "near-strategic defeat". Serviced mainly by Sunni radicals from the wider Arab world, al-Qaeda in Mesopotamia (as it calls itself) was responsible for most of the huge car bombs that terrorised Shia communities and provoked their backlash of sectarian cleansing, almost tipping Iraq into full-scale civil war two years ago. Such bombings and sectarian attacks are now scarcer.

Down but not out

But al-Qaeda is certainly not defeated. It is still active in the mixed Sunni-Shia province of Diyala and in the northern city of Mosul and its surrounding Nineveh province. It attacks the tribal leaders of the Sunni Awakening (or *Sahwa*) movement, for instance in the western province of Anbar, who have been persuaded to throw in their lot with the Americans. Most Sunni Arabs have turned strongly against it.

AP

Another reason for the drop in violence is that the mass movement loyal to a fierce Shia cleric, Muqtada al-Sadr, has also either decided to back off, perhaps just for the time being, or has been beaten back by a mixture of American and Iraqi government forces. Earlier this year, Sadrist violence had risen, culminating in March in a big battle for the southern port city of Basra. At first, the Sadrists seemed to have fended off attempts by the Iraqi army to squash them. The Sadrists' Mahdi Army militias elsewhere in southern and central Iraq and in the eastern slums of Baghdad known as Sadr City rose up in solidarity with their brothers in Basra. From their base in Sadr City, on the opposite side of the Tigris, they subjected Baghdad's Green Zone to a hail of mortar and rocket fire.

But in mid-May they accepted a truce. Since then, the Iraqi army has been able to patrol Sadr City more or less unmolested, uncovering

weapons caches and sniffing out leaders of so-called "special groups" of renegade Sadrists who appear to be beyond the control of Mr Sadr himself. The government will get a big boost if it can at last bring basic services into the wretched slums of Sadr City, such as electricity, sanitation and medicine. In Basra too, after an astonishing turn-round, the Iraqi army seems to have bested the Sadrists.

A chance to build

Yet the Sadrists still have a wide base of support, especially among the poor. Mr Sadr himself may be planning to turn his movement into a mainstream political-cum-religious party. The prime minister, Nuri al-Maliki, aiming his wrath at the Sadrists, has said that no party may take part in the provincial elections unless it first disbands its militias. No one expects the Mahdi Army to disband fully—and no one is sure how much control Mr Sadr has over his movement's fractious components. He may manage to persuade most of his militiamen to stand down. But if Mr Maliki seeks to disbar the movement from competing in the elections, the Sadrists may still run as independents—and could yet sweep the board in the south.

In the north, further progress in pacifying Mosul and its surrounding area would allow the government to claim with some justification that it is winning the war. The city is a last redoubt of al-Qaeda and a bastion of nationalist Baathists. By most accounts, government forces, with the Americans, are making steady advances.

The government has gained in confidence too. Mr Maliki's reputation has risen sharply since his forces' success in Basra, particularly among Sunnis and Kurds, many of whom praised him for showing that he was prepared to take on the militias from within his own Shia community. Since then, Western diplomats in Baghdad have noticed Mr Maliki's growing readiness to take decisions without conferring with the Americans first.

He is trying to strengthen his nationalist credentials in negotiations between his government and the American administration over a "status of forces agreement". Mr Maliki wants to end the UN's formal sway over Iraq enshrined in an agreement renewed periodically since the invasion. He would like to replace it with a bilateral deal that would curb American powers—for instance, the power to detain Iraqi citizens, to launch military attacks without having to consult the Iraqi authorities, to fly through Iraqi airspace at will, and to give American soldiers and contractors immunity from prosecution if they break Iraqi laws.

In reality, Mr Maliki still relies on the Americans, so he is unlikely to force the issue. Moreover, the results of provincial elections in the autumn and of America's own presidential election in November may sharply change the political landscape. So he may well let the matter drag on towards the end of the year. But he has been flashing his nationalist teeth—and may yet succeed to some degree in shifting power from the occupier to the government of a sovereign country.

An oil-fired recovery

If, with the government's growing political and military authority, Mr Maliki could get the economy moving, then the much-uttered phrase “turning the corner” may be apt. Iraq's windfall from higher oil prices is grand. America's State Department reckons that, if prices stay put, Iraq this year should earn more than $70 billion, though this year's budget projected $35.5 billion based on $57 a barrel at a production rate of 1.7m barrels a day. The latest production figure is 2.53m, a shade higher than its pre-war peak.

So far the cash has yet to be turned into decent public services. People in Baghdad say that they have only a few hours of state-provided electricity a day; the Americans admit that the Baghdad average is seven hours. A vaunted advance is in telephony: there are now 12m cellular phones, against a handful before the war, and 261,000 Iraqis subscribe to the internet, against almost none before the war.

Yet the biggest obstacle to economic progress is the lack of qualified people and civil servants to make use of the cash pouring in. The ministries spent barely half of their capital budgets last year, while provincial governments used up less than a third, according to an American government watchdog. Thanks partly to the “de-Baathification” decree of the early American administration which chased out the senior ranks of Saddam's old bureaucracy, the state virtually ceased to function. But what is left of the old civil service may be starting to operate better again. Professor Toby Dodge, a British expert who has been sceptical of many of the American administration's past policies in Iraq, says that “the state is beginning to re-cohere”.

There is a long way to go. Much of the middle class has fled; many of its members have been killed. According to the UN's High Commissioner for Refugees, some 2.8m Iraqis are still displaced within the country; another 2.2m-plus have gone abroad, out of an original population of 27m or so. The official unemployment rate is 25-40%; in reality, it may be a lot higher. Businessmen and investors have yet to come back.

For there is still a risk of renewed general violence, not least from within the Shia community, where power is being sought by four main rival parties. The provincial elections are rightly promoted as the next crucial political event. The hope is that they will bring the Sunnis back into the fold of peaceful politics. But they could also unleash a furious cycle of intra-Shia violence, either if the Sadrists compete and win or if they compete and believe they have been cheated of victory.

As for the Sunnis, who are now often divided between the ascendant *Sahwa* movement and the older declining Islamic Party, Mr Maliki remains loth to draw them fully into his circle of power. If they continue to feel left out, they could easily turn their weapons once again against the new Shia-led establishment.

Meanwhile, the Kurds in the north are quietly consolidating their autonomy and peacefully making progress on all fronts, hoping that Iraq's Arabs will fully accept that federalism is the way to go. But they are angry that a promised referendum to determine whether the oil-rich province of Kirkuk should become part of their region is again sure to be delayed. In their hearts, most Kurds still hanker after full independence, even if many know in their heads that it is not practicable.

Iraq's future is still full of pitfalls. The sectarian chasms remain deep, the wounds of strife raw. But for the first time since the insurgency against the Americans took off, the tide, which may quickly ebb, is flowing in the direction of the new order.

Economist.com BRIEFINGS

The American election and Iraq

The war for the White House

Jun 12th 2008
From The Economist print edition

Calculating the impact on America's presidential campaign

AP

Lest anyone forget

HOW much of a millstone is Iraq to John McCain, as he strives to become America's next president? Although the Republican candidate strenuously tries to avoid the charge that his presidency will amount to nothing more than a third term for George Bush, his support for the war is the single clearest policy difference between him and Barack Obama. Mr Obama's supporters are never likely to cease trumpeting that, back in 2002, from his perch in the Illinois Senate, he denounced the prospect as a “dumb” adventure which would lead to “a US occupation of undetermined length, at undetermined cost, with undetermined consequences.”

That proved remarkably prescient. And the polls suggest most Americans agree with Mr Obama. A recent poll for CBS shows 62% of Americans believing that the war is going badly, and 61% thinking that Iraq will “never” become a stable democracy.

Mr McCain, however, does have a few trumps to play. He correctly foresaw that the “surge” of troops into Baghdad and its region last summer would produce results. In fact, Mr McCain had been calling for the surge for three years before it happened. Last spring Mr Obama, by contrast, joined other Senate Democrats in trying not just to block the surge but to force Mr Bush into a timetable for ceasing all combat in Iraq within a year. Mr McCain is probably right to say that the consequences would have been chaotic and bloody.

In common with most Democrats, Mr Obama is also guilty of having shown little public recognition that the facts on the ground have changed materially in the past months. Mr McCain will try to paint his opponent as both blind to reality and a “Defeaticrat”—the charge of defeatism to which Democrats are perennially vulnerable. Mr Obama has pledged to withdraw one or two combat brigades each month and to have all troops out within 16 months (save for those needed to protect the American embassy and,

perhaps, to attack any al-Qaeda hideouts in Iraq). Mr McCain can argue that such a strict timetable is risky.

For his part, Mr McCain is haunted by a remark he made in answer to a question at a campaign event. He said he would not object if American troops remained in Iraq for 100 years. The context makes clear that he was speaking of the possibility that some American forces may remain indefinitely after the fighting was over, as they have in Germany, Japan and South Korea. But Mr Obama gleefully pretends that he promises 100 years of war. This charge is hard to rebut, because Mr McCain has imposed no limit on the length of time that he would keep up the fighting. The furthest he has gone is to state that the majority of troops may be home by the end of his first full term (in January 2013).

Two factors may cheer the Republican. The first is that the anti-war vote is highly partisan. Some 83% of Democrats, according to CBS, think the war is going badly, while only 29% of Republicans think so. Independents, who are the voters that will determine the election, are much more evenly divided, though a majority do take the Democrats' view. Americans tend to prefer Mr McCain to Mr Obama as a commander-in-chief.

The other point is that, come the election, it is likely that no one will be paying that much attention to the war. The Project for Excellence in Journalism compared network news coverage in early 2007 and 2008, and found that the share of airtime devoted to Iraq fell from 22% of the total to 4%. If the economy continues to worsen, that share could fall even further. Although that sounds like good news for Mr McCain, the bad news is that his economic policies are viewed by many voters as being just as close to Mr Bush's as his policy on Iraq.

The new Democratic establishment

Who's who in Obamaworld

Jun 12th 2008 | WASHINGTON, DC
From The Economist print edition

A guide to the main players in Barack Obama's aspiring administration

Reuters

NOT everyone believes in Barack Obama's promise to change Washington. But at least the faces will change. Should he win the White House, Mr Obama will bring in a new team to run the federal government, the Oval Office and the Democratic Party. Sitting Republicans, of course, will be out. But so too will be many members of the old Democratic establishment, long exiled to the Brookings Institution and similar perches to await the return of their powers under Hillary Clinton. So who will run the country if the voters decide that Yes, He Can?

On domestic matters, Mr Obama has assembled a team of sharp academic economists who premise their work on his supposed ability to sell sophisticated policy. Most prominent up until now has been **Austan Goolsbee** (pictured first left above), a University of Chicago professor whom many expect to head a President Obama's Council of Economic Advisers. Mr Goolsbee's record suggests neither the hostility towards globalised capitalism nor the desire for large-scale redistribution that conservatives, spooked by tales of Mr Obama's left-wing voting record, might fear: Mr Goolsbee is a problem-solver who favours such unsexy proposals as altering American tax forms. He got into trouble earlier this year for telling the Canadians not to worry too much about the anti-NAFTA rhetoric the candidate was emitting on the campaign trail.

From Harvard Mr Obama plucked Jeffrey Liebman, who has produced good research on the earned-income tax credit and its role in moving people from welfare to work, and David Cutler, a health economist who wants doctors' pay tied to medical outcomes. As of this week, though, Mr Obama's newly appointed economics director is **Jason Furman** (second left, above), an economist in the Clinton administration and a top aide to John Kerry in 2004. His presence rebuts criticism that Mr Obama's team has too little policymaking experience. Mr Furman, too, hews to the non-ideological centre, heading Washington's Hamilton Project, an economic policy group co-founded by Bob Rubin, once Bill Clinton's treasury secretary. Mr Furman is a staunch free-trader who once praised Wal-Mart and has favoured

lowering corporate taxes. With a PhD from Harvard, he also does not lack for academic credentials.

Bill Galston, a former senior adviser to Mr Clinton, argues that the campaign, for all its braininess, has so far failed to frame its proposals in a “narrative” about the economy. But the campaign's post-ideological message may fit into a broader theme about Mr Obama's style of politics: that he can unite Americans behind reasoned policy as their problems pile up.

Mr Obama's plans for “change” are most concrete in his determination to leave Iraq. Indeed, his early opposition to the war attracted seasoned foreign-policy practitioners who also disapproved of the invasion. The biggest name among them is **Tony Lake** (third), Mr Clinton's national security adviser, who taught the ex-president how to salute and who toiled to bring peace to the Balkans. Others in Mr Clinton's top tier—such as Madeleine Albright and Richard Holbrooke—backed Mrs Clinton, leaving room for up-and-comers to nab the best spots in the Obama campaign. **Susan Rice** (fourth), Mr Clinton's assistant secretary of state for African affairs, is a possible national security adviser. The Rwandan genocide deeply affected Ms Rice, who now wants more done to end killing in Darfur; her prominence suggests that President Obama might attend more closely to north-south issues.

Before resigning from the campaign for calling Mrs Clinton a monster, Samantha Power, an academic who has written about genocide, tried to soften Mr Obama's commitment to pull all troops out of Iraq. She will probably find a place in an Obama administration. The campaign boasts some former military brass, including Richard Danzig, a former secretary of the navy and possible defence secretary. Mr Obama is also likely to bring in experienced former ground commanders such as Wesley Clark. And, despite tales of a deep mutual antipathy between Mr Lake and Mr Holbrooke, it would be foolish to rule the pugnacious Mr Holbrooke out of contention for a big job.

But policymaking is harder than writing theories. First, one must get elected. Afterwards, one must win battles with Congress and the public. For both, Mr Obama will look to his political team. Foremost here is **David Axelrod** (fifth), the man who made “change” into a campaign theme. His consultancy helped elect two mayors in rough-and-tumble Chicago, and he can deliver a punch: he was once accused of producing an ad that made an opponent resemble Hitler. Even so, he seems a true believer in Mr Obama's hopeful rhetoric. “I find myself getting very emotional about it,” he told the *Los Angeles Times*. All assume he will be Mr Obama's Karl Rove.

Also surrounding Mr Obama are well-connected Chicagoans who supported his Senate run in 2004, when he was an unknown state legislator. Valerie Jarrett, a former head of the Chicago Stock Exchange, is the person who can tell the Obamas uncomfortable truths. Penny Pritzker, the campaign's finance chair and a property billionaire, supposedly joined the campaign after her husband banged their kitchen door, proclaiming, “this is destiny knocking on the door of our nation,” (though the couple seem normal in other respects).

A big part of Mr Obama's success, though, is due to the Democratic operators he lured from elsewhere. His campaign manager, **David Plouffe** (sixth), a former aide to Dick Gephardt, is disciplined and parsimonious, overseeing the amassing of the biggest political piggybank ever seen and orchestrating Obama victories in small, organisation-intensive caucus states.

Mr Plouffe's chief organisers are Steve Hildebrand and Paul Tewes, who ran Al Gore's successful Iowa caucus bid in 2000. Mr Tewes will soon move to the Democratic National Committee to head its presidential campaign effort—and consolidate Mr Obama's control of the party. Tom Daschle, a former Senate majority leader, could help Mr Obama's team put pressure on Congress without alienating its members, a problem that can dog first-term presidents.

The ambition of Mr Obama's team is exciting, but in office it could be dangerous. In 1993 the clever Clintons tripped up very quickly. What if Congress doesn't care for the finely-tuned policies of Mr Obama's top-notch economists? Or if Mr Obama finds he can't pull out of Iraq as planned? Or if Americans tire of his charisma and he stops being able to attract adoring crowds tens of thousands strong? The lynchpin of his campaign has been a faith, almost messianic, in his personal excellence. If that fades, then the whole operation could collapse in frustration and disillusionment.

The economy

The battle of the pockets is joined

Jun 12th 2008 | WASHINGTON, DC
From The Economist print edition

The candidates' tax and spending plans are examined

THE most recent unemployment figures have hit Washington like a brick: the unemployment rate jumped to 5.5% in May, a hefty half-point hike from April. Much of the rise came from young Americans unsuccessfully seeking work for the first time, but the capital is again buzzing with recession worries. What better time, therefore, for the two presumptive nominees to battle over their economic plans?

And battle they have. On June 9th Barack Obama began a two-week tour to battlefield states, his first as his party's anointed leader, with a big speech on economic policy. He accused John McCain of favouring George Bush-like profligacy by proposing tax cuts he can't pay for. Mr McCain shot back with a speech of his own next day, saying that Mr Obama will raise taxes and unwisely renegotiate trade agreements. Strangely, both of them may have a point.

During the primary campaign Mr Obama decried exporting jobs to China and getting tainted medicine in return, with scarcely a mention for America's booming export sector (though his tone on trade is already starting to soften a bit.) And he does want to raise taxes on high-earning Americans to pay for new spending on health care and helping poor people save. Mr Obama wants to raise the top income-tax rate from 35% to 39.6%—its pre-Bush level—and the tax on capital gains to perhaps 25% from 15%. Mr Obama also wants to add some new corporate taxes. And he has spoken repeatedly of removing the earnings cap on payroll taxes, which, along with his other proposals, would increase the top marginal tax rate to over 46% of earned income. (State income taxes, which range from 0% in Texas and half a dozen others to around 9% in the most expensive states, including California, New Jersey and Washington, DC, come on top of that.) But his campaign, filled with centrist academic economists, has not proposed specifics, and Mr Obama said this week that he might even defer some of his tax hikes depending on economic conditions when he takes office.

On the other hand, Mr Obama correctly reckons that the attractive tax cuts Mr McCain proposes could pummel the federal budget. The Arizona senator wants to keep all of Mr Bush's tax cuts in place, lower the top corporate income tax rate by ten percentage points and scale back the Alternative Minimum Tax, a confusing scheme aimed at preventing Americans from claiming too many deductions on their tax forms. Mr McCain says he can pay for all this by cutting government spending, starting with the earmarks lawmakers use to direct money to pet projects. But he will have to cut much deeper than that, and most analysts reckon that he hasn't said in convincing detail how he will do it.

So how much money would Mr Obama's plan raise, and how much would Mr McCain's lose? On June 11th the Tax Policy Centre, a Washington think-tank, estimated that, compared to current policy, the Democrat's proposals would bring in an extra $700 billion over ten years (not including the revenue gains from the mooted removal of the payroll cap, which it did not quantify) while the Republican's would lower the government's take by $600 billion over the same period.

Both plans would probably see big increases in the national debt over the next decade—and none of the figures include any costs associated with the candidates' health-care reform plans, which are too vague to be accurately costed. And both conjure up cash that may not materialise: Mr McCain hopes he can avoid crushing deficits with mysterious spending cuts, while Mr Obama relies on varied measures his campaign claims would somehow raise almost a trillion dollars over a decade.

The figures are debatable, but there is one clear difference. Mr Obama's plan would redistribute cash to lower- and middle-income Americans, while Mr McCain's would skew benefits towards the wealthy. That's something voters may find it easy to take a view on.

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WORLD
UNITED STATES

The Democrats unite

All together now

Jun 12th 2008 | WASHINGTON, DC
From The Economist print edition

Barack Obama hits the ground running

Alamy

Gracious in victory

ON JUNE 11th Barack Obama hit his first reverse since securing the Democratic nomination the previous week. Following five days of bad publicity, he was forced to dispense with the services of the man he had chosen to help him select his running-mate. James Johnson allegedly received favourable treatment from a mortgage company while he headed Fannie Mae, a government-sponsored agency that was a big customer of the company in question. He denies any wrongdoing, but the row was hurting the candidate.

That bump aside, Mr Obama has been keeping up the pace. Hillary Clinton held out for four days before conceding, but finally did so gracefully on June 7th. Having spent months insisting Mr Obama is under-qualified for the Oval Office, she changed her mind and said that, on reflection, he would put the country back on the path to peace, prosperity and progress.

Mrs Clinton said her campaign left “about 18m cracks” in the “highest, hardest glass ceiling”. But some of her feminist fans seethe that their heroine worked hard for decades, only to be shoved aside by a pushy, flashy, inexperienced young man. This group may be reluctant to support Mr Obama, although Mrs Clinton urged them all to do everything they can for him.

Mr Obama is using all his charm to coax disaffected Hillaryites onto his side, praising Mrs Clinton for running an historic campaign that shattered barriers on behalf of “my daughters and women everywhere”. Meanwhile, his campaign reached out to Mrs Clinton's, partly to poach talent but mostly to encourage her donors to start giving money to him.

Mr Obama is reportedly on track to raise an astonishing $100m in June, which must surely tempt him to opt out of the more parsimonious public-financing system he once promised to use. Mr McCain, who has not raised nearly as much money as Mr Obama, will accept public funds for the general election. Whether or not backtracking on his promise will hurt Mr Obama remains to be seen.

After the briefest of breaks following his primary victory, Mr Obama began a tour of swing states to court wavering independents. He has reprised some of the populist tunes that worked so well for him in the primaries, such as the riff about the man who lost his job but can't afford the gas to drive around looking for a new one, but now that he is courting the whole electorate, not just Democrats, he is sounding a bit less populist about trade.

Mr Obama is receiving energetic assistance from Democratic interest groups. Labour unions are picketing John McCain's speeches and distributing a booklet called “McCain Revealed”, which reveals the senator to be—wait for it—economically conservative. NARAL Pro-Choice America, a lobby that favours legal abortion, has launched a “Meet the Real McCain” campaign to remind voters that he does not.

Mr McCain, who had all but won his party's nomination by mid-February and has been campaigning for the general election ever since, carried on much as before. His latest television spot reminds voters that his father left to fight in the second world war when he was five, that his grandfather came home from

that war and died the next day, and that Mr McCain himself was a prisoner of war for five years. “I hate war. And I know how terrible its costs are,” Mr McCain tells viewers in swing states. “I'm running for President to keep the country I love safe.”

Mr Obama has yet to agree to Mr McCain's suggestion that the two of them hold joint town-hall meetings and take questions from ordinary voters together, but sounds open to the idea. Such an exercise would illuminate the contrasts between the candidates: one eloquent, thoughtful and mostly focused on domestic affairs, the other affable, pugnacious and interested mostly in national security. Who wouldn't want to see that?

Al Franken

Lighten up

Jun 12th 2008
From The Economist print edition

A comedic Senate campaign

AP


Not so funny now

AN IMPLAUSIBLE politician has just become somewhat less so. On June 7th Al Franken, a former comedian on "Saturday Night Live", radio commentator and author of books such as "Lies and the Lying Liars who Tell Them: a Fair and Balanced Look at the Right", won the endorsement of Minnesota's Democratic-Farmer-Labour party (DFL) for the post of senator.

In an era in which presidential candidates compete on comedy shows, it may not be surprising that a former comedian fancies himself a politician. But comedians have an unfortunate habit of making jokes. Mr Franken's path to the DFL nomination was fraught, thanks in part to "Porn-O-Rama!", a fantasy he wrote for *Playboy* in 2000. Defeating the Republican incumbent, Norm Coleman, will be even more harrowing.

Mr Franken has never run for office before, at least not in the real world. He did once produce a satire, "Why Not Me?", in which he was elected president on the single issue of cutting ATM fees, and then went mad and plotted to kill Saddam Hussein by beating him with a plaque reading "the world's greatest granddad".

His Senate campaign is, for better or worse, more demure. A main task has been to convince Minnesotans that he is one of them—he grew up there, but spent much of his adult life in New York. It helps that he has traversed the state campaigning for other DFLers. At a recent DFL dinner in Mankato, in southern Minnesota, he chatted comfortably about the flaws of their Republican governor and the merits of Minnesotans' egg coffee, made with both the yolk and the shell.

The harder job is to prove that he is serious enough for the Senate. Like many others trying to unseat a Republican, Mr Franken is fond of hyphens, blaming various "Bush-Coleman" policies for America's predicament. But he can also be wonky, and speaks soberly about universal health care and support for war veterans.

Nevertheless, few candidates could inspire enemies to such gleeful moustache twirling. A Republican blogger helped lead Mr Franken to admit in April that he owed $70,000 in taxes—he had paid taxes on his income, but not in all the right states. Worse news came in May, when state Republicans merrily re-presented "Porn-O-Rama!". Then, just before the DFL's convention, the party unveiled an article from *New York* magazine in 1995 that describes Mr Franken joking about rape. Mr Franken has apologised, but the resurrection of Sexbots from "Porn-O-Rama!" was hardly ideal for the founder of a "midwest values" political committee.

Despite all this, Mr Franken managed to defeat his opponent, an academic, and win the DFL's endorsement. He has tempered his rowdy sense of humour and is trying to direct attention to his policies. But his work as a comedian is a bottomless treasure chest for Republicans. Expect more Sexbots.

California politics

The anti-governator

Jun 12th 2008 | LOS ANGELES
From The Economist print edition

Jerry Brown wants to be governor of California again

ARNOLD SCHWARZENEGGER may be less than halfway through his final term as California's governor, but the slow dance to replace him is already under way. One figure looms above all others. Jerry Brown is not, you understand, running a campaign just yet. But he has begun to raise money and muse publicly on the state's future. He begins a sentence with: “Were I to be governor”. As he himself puts it, he would not be behaving any differently if he were in the race.

Mr Brown has the best surname in California politics. His father, Pat Brown, was the state's chief post-war architect, overseeing an extraordinary boom in freeways, aqueducts and universities. The son has already served two terms as governor, beginning in 1975 and 1979, and two as mayor of Oakland. He was California's secretary of state and is now its attorney-general. He also found time to study Buddhism and Spanish, work with Mother Teresa and run for president three times.

Like many veteran politicians, Mr Brown has a complex, contradictory record; unlike most, he sometimes appears to change his mind several times in the course of a conversation. Known for his firm opposition to the death penalty, he has also acquired a reputation as a law-and-order strongman. He espouses pragmatic, limited government and is one of the few successful politicians to run on a platform of lowered expectations. But Mr Brown enlivens this rather dry philosophy with frequent flights of fancy. In the 1970s he tried to establish a state space programme, earning the nickname “Governor Moonbeam”.

Mr Brown is a more sober politician these days—the experience of running gritty Oakland brought him down to earth—but he hasn't lost his esoteric streak. Latin quotes and musings on the impermanence of life pepper his speeches. He asks your bewildered correspondent about German environmental policy and 16th-century history. He is a startlingly cultured man in what is sadly an often boorish profession.

He can also see the future, and does not like it much. While the current governor is almost invariably sunny and upbeat, Mr Brown sees daunting problems ahead for California. He is inclined to run for governor on a platform of holding the state together “with baling wire and scotch tape”. How such glum talk goes down on the coast of dreams remains to be seen, but Mr Brown's forecast is almost certainly right.

As he well knows, a nasty surprise awaits the next governor. In 2006 California passed an environmental law that committed the state to drastic reductions in greenhouse-gas emissions by 2020. It is a bold pledge—indeed, probably an impossible one—that will require painful sacrifices. These will be spelled out by a state board two years after Mr Schwarzenegger leaves office. A backlash is almost inevitable. Last year, as attorney-general, Mr Brown sued the city of San Bernardino to force a change to its urban plan, which called for sprawling growth. In response, Republican legislators held the state budget hostage.

California groans with debt—a result of Mr Schwarzenegger's Pat Brown-like enthusiasm for roads and waterways, together with his distaste for tax increases. And California's slowing economy means there is worse to come. This year's budget features an accounting wheeze that involves borrowing against future lottery revenues. The next governor's bills are already piling up.

Mr Brown is already 70. He will seem even older if Gavin Newsom, San Francisco's dashing mayor, decides to run for the state's top job. But the old man will be a formidable opponent. After Mr Schwarzenegger's bluster, a modest, slightly crotchety governor may be just what Californians want.

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UNITED STATES

Innovation

What crisis?

Jun 12th 2008 | WASHINGTON, DC
From The Economist print edition

Worries that America is losing its edge in science and technology are overblown

“THE wolves have not encircled us yet,” the *Denver Post* opined in an article in 2006 entitled “Signs America's Scientific Edge is Slipping”, “but there's no denying the sounds of scratching at the door.”

This was a pithy summary of a mountain of reports from congressional committees, scientific panels and business groups. But a new report from the RAND Corporation's National Defence Research Institute, “US Competitiveness in Science and Technology”, suggests that the panic is overblown.

The report demonstrates that America is still the world's science and technology powerhouse. It accounts for 40% of total world spending on research and development, and produces 63% of the most frequently cited publications. It is home to 30 of the world's leading 40 universities, and employs 70% of the world's living Nobel laureates. America produces 38% of patented new technologies in the OECD and employs 37% of the OECD's researchers.

There is little evidence that America is resting on its laurels, according to RAND. Developing countries such as China and India may be boosting their science and technology muscle faster than America. But they are starting from a low base. America is outperforming Europe and Japan on many performance measures: in 1993-2003 America's growth rate in patents averaged 6.6% a year compared with 5.1% for the European Union and 4.1% for Japan.

One reason for America's angst was that the growth of federal spending on R&D slowed significantly with the end of the cold war. It only grew by 2.5% a year in 1994-2004 compared with a long-term average of 3.5% since 1953. The trouble with this statistic is that America has lots of sources of R&D spending: federal money accounted for only $86 billion of the $288 billion that it spent on R&D in 2004. Spending on the life sciences is increasing rapidly, a reasonable bet on the future.

Others worry that non-US citizens now account for 41% of science and engineering PhDs. But this is arguably a sign of America's continuing world domination: the world's brightest people are gravitating to the world's best opportunities. A higher proportion than ever of these paragons want to make their homes in the United States.

The border

Fighting the fence

Jun 12th 2008 | EL CALABOZ, TEXAS
From The Economist print edition

Texans and owls take on the federal government

NO SOONER has Eloisa Tamez parked on the dirt road that runs through her backyard in El Calaboz than a big car trundles up to investigate. “And here comes the famous Border Patrol. They're curious,” she says drily. The agent behind the wheel has recently moved down from Oklahoma, and she chides him for not knowing the history of this little stretch of the border. It was given to her family in 1767 as part of the Spanish land-grant programme. Although it has been nibbled away over the years, she still has several acres, and she does not want the Border Patrol tramping around on it.

Ms Tamez, 72, seems mostly amused by the encounter. But she has a bigger problem than greenhorn agents. Last year the Department of Homeland Security (DHS) asked to survey her land. It plans to put some 700 miles (1,100km) of fencing along the border between the United States and Mexico by the end of George Bush's term, and wants a bit of it to go through her land. Ms Tamez declined. The department sued for access. She countersued, saying that the department had not tried to negotiate with her in good faith. She says that she wants to make the DHS follow the constitutional procedures, but she is not very optimistic.

Ms Tamez's situation is unusual, but she is far from alone. Opposition to the fence is running high in Texas, partly because heavy-handedness from the DHS has inflamed the situation. In April Michael Chertoff, the cabinet-level secretary of the department, announced that he would use his powers of waiver to brush aside more than 30 laws in order to begin building this July. In May a group of mayors, judges and other officials calling themselves the Texas Border Coalition (TBC) filed a class-action lawsuit, saying that the DHS has trampled on people's property rights. Several environmental groups have also sued, contending that the fence will cut through a wildlife corridor.

It is a lot of commotion over a relatively small amount of wire. The Texas part of the border is 1,200 miles long, but plans call for only 70 miles of it to be fenced. Consider the Del Rio sector, which is about 200 miles long. It is mostly deeply inhospitable brush and canyon country. Alan Langford, the assistant chief patrol officer of the sector, says that the DHS wants to put less than five miles of fencing around two cities, Del Rio and Eagle Pass. “Just to get people away from crossing in the urban areas,” he explains. When someone crosses the border into a city, they can quickly blend into the crowd.

Chad Foster, the head of the Texas Border Coalition and the mayor of Eagle Pass, questions the need. He says that his city has a happy relationship with Piedras Negras, its larger counterpart across the river. He thinks the DHS would do better to clear the city's riverbanks of corrizo cane, which offers effective cover

to anyone in need of a hiding-spot. “There's a misconception in mid-America that Mexico is overrunning the borders,” says Mr Foster. He suggests that the rest of America fence their own communities if they feel insecure.

The idea that the fence will be pointless is a common objection in the Rio Grande valley. Most border crossings there are legal and normal, and locals doubt that would-be illegal immigrants will be discouraged by the idea of walking around a fence. The project will certainly be expensive. A 2006 report put the cost of building and maintaining the entire border fence at $49 billion over 25 years. That money could be spent on more sophisticated technology, such as sensors or drones.

Fence-building strikes many people as paranoid. There are frequent comparisons to the Berlin Wall. Some people point out that Texas, unlike New Mexico, Arizona or California, already has a well-defined physical border with Mexico—the Rio Grande. The fence would be built a bit north of the river, and that might look like the state is ceding strips of land back to Mexico. A fence would also block access to the water. “It's hard for us to imagine a wall separating us from the river,” says Rick Villareal of Laredo, who grew up swimming in it.

Mr Chertoff may be taken aback by all the complaints. There was not nearly such a loud outcry in the other border states. But he has vowed to press on and seems particularly annoyed by the environmentalists. He says he has attended too many memorial services for Border Patrol agents to muster much sympathy for “the sensitivity of an owl”. Owls are one thing. Property owners are a lot harder to dismiss.

Lexington

Such sweet sorrow

Jun 12th 2008
From The Economist print edition

Europeans will not miss George Bush. But rebuilding the transatlantic relationship will not be easy

Illustration by Kevin Kallaugher

IT WAS not difficult to distinguish between George Bush's farewell visit to Europe this week and a victory lap. True, things have sometimes been even worse: back in 2003 he was greeted by some of the biggest protests in European history. But this time he was being greeted by sullen indifference. Mr Bush is worse than a failure in European eyes. He is yesterday's failure.

Across the continent Bush hatred has been replaced by Obamamania. Barack Obama is playing the “good American” to Mr Bush's ugly one—articulate where Mr Bush was cloth-tongued and cosmopolitan where Mr Bush was Texas-insular. Europeans are perhaps even more entranced than Americans by Mr Obama's message of “change” and “hope”. They are also being forced to rethink some of their deepest prejudices about America. How can the land of “Stupid White Men” produce a Barack Obama? And how can Europe go on feeling quite so superior to America when it treats so many of its own minorities so badly? The French parliament has only one black person representing mainland France.

John McCain hardly enjoys Obama-like levels of enthusiasm. A new Pew poll shows that, in both France and Germany, only about 30% of people think that Mr McCain will do the “right thing” in foreign affairs compared with more than 80% for Mr Obama. But the Republican senator is still regarded as a huge improvement on Mr Bush. He has spent decades networking with European leaders, for example as a regular at the annual Munich Conference on Security Policy.

Just as significant for the future of the alliance is that both candidates agree on the importance of reversing the collapse of America's image in Europe. They are both determined to tackle three of its root causes—by banning torture, closing Guantánamo Bay and embracing a cap-and-trade policy on climate change. Here Mr McCain is proving himself, if anything, to be the bolder Atlanticist of the two, not only praising the relationship more loudly but also pitting himself against powerful groups within his own party, including the White House.

The two senators will also inherit plenty of materials for bridge-building. The Bush administration has pursued a much more conciliatory policy since 2004. Indeed, Condoleezza Rice, Mr Bush's secretary of state, argues that, in some ways, the relationship is deeper than ever before: for the first time ever NATO forces are fighting outside the European theatre, in Afghanistan.

Two pro-Americans, Angela Merkel and Nicolas Sarkozy, have replaced the troublesome Gerhard Schröder and Jacques Chirac in Berlin and Paris. Mr Sarkozy has been particularly vocal in praising America and embracing a more pro-American position on Iraq and Iran (he argues that an Iranian nuclear bomb is “unacceptable”, for example). It is notable that when Mr Sarkozy visited Washington back in 2006 the only two people he found time to see on Capitol Hill were Messrs Obama and McCain.

The only worry is that things are looking a bit too good at the moment. The biggest danger for transatlantic relations now comes from out-of-control expectations—particularly where Mr Obama is concerned. Obamamania may be less of a problem than Bush derangement syndrome. But it contains the seeds of its own destruction. The world's dictators will be less inclined to melt before Mr Obama's charm than New England college professors. And, as the world's only superpower, America has no choice but to continue to worship Mars as well as Venus.

Mr Obama gave a hint of possible future tensions with Europe in a speech he delivered to AIPAC hours after winning the nomination. He declared that “Jerusalem will remain the capital of Israel” and that “it must remain undivided”. He dismissed the Palestinian “right of return” (“Israel's identity as a Jewish state must be preserved”). He hedged on his promise to meet Iran's president, Mahmoud Ahmadinejad, and declared that “I will do everything in my power to prevent Iran from obtaining a nuclear weapon; everything in my power; *everything.*”

Plus ça change

The speedy collapse of a cap-and-trade climate bill on June 6th also hinted at problems to come. The bill was the most ambitious to reach the Senate floor thus far, and enjoyed bipartisan support. But it collapsed without a single vote. Optimists argue that the bill is just a dry run for a successful push under a different president and with a different constellation of power in Congress. But pessimists rightly point out that Americans face a harder job adjusting to higher energy prices than Europeans, given their dependence on cars and taste for suburban living. Paris, Texas, is not Paris, France; $4-a-gallon petrol is already creating widespread angst. Any politician who promises ever-rising energy prices, even in a good cause, faces obliteration.

Mr Obama's views on trade could also spell problems for the relationship. In a speech in Raleigh, North Carolina, on June 9th he declared himself a free-trader. But in the Ohio and Pennsylvania primaries he saturated the airwaves with ads denouncing NAFTA for devastating entire American cities. He also favours tougher standards on labour and the environment in trade deals. Mr Obama feels about free trade exactly what most Americans feel about tackling climate change—it's a great idea so long as it involves all gain and no pain.

The transatlantic relationship faces very different problems from the ones that plagued it in the Bush years. But it faces problems nonetheless. Avoiding disappointment will require a careful management of expectations from both sides. It will also require hard work. The American presidential candidates have already demonstrated that they are willing to invest in rebuilding the relationship. It is now up to the Europeans to produce some concrete suggestions of their own. They should not wait until January 2009 to get their act together.

Hugo Chávez

Master tactician or failing bungler?

Jun 12th 2008 | CARACAS
From The Economist print edition

AP

Latin America's self-styled Bolivarian hero may be losing his populist touch

Get article background

HUGO CHÁVEZ has never been one to worry about a little inconsistency. Venezuelans, along with their neighbours, have become accustomed to his habit of switching from firebrand to conciliator and back again, with barely a pause for breath. But even by his own remarkable standards, Venezuela's left-wing president has recently been showing new virtuosity in the art of making surprising U-turns.

In January this year he told a startled world that the FARC guerrillas in neighbouring Colombia should be treated not as terrorists, as they are by most countries, but as an "insurgent force", with rights under the laws of war. On June 8th he surprised everyone again by calling on the same guerrillas to give up the struggle they had waged for four decades, release their 700 or so hostages and recognise that guerrilla warfare in Latin America "is history".

In this latest reversal Mr Chávez is plainly doing his belated best to extract himself from an embarrassment. Computer files seized by Colombia during a raid on a FARC camp inside Ecuador two months ago appeared to confirm that Venezuela has been helping the guerrillas—and that Mr Chávez's call for an upgrading of the FARC's status was part of a strategy he had cooked up with its leaders.

At Colombia's behest, Interpol has inspected the computer drives and confirmed that they have not been tampered with. Venezuela says their content is fabricated: its government is mounting a propaganda offensive to convince the world of that. But the fact that many governments have been queuing up to ask Colombia whether their own intelligence services can see the files suggests that they believe the contents to be genuine. And although Colombia has its detractors in the region, most countries consider it bad manners to provide help to a guerrilla movement that is inflicting mayhem on its neighbour.

Even before the dent this affair has now put in his international reputation, Mr Chávez had troubles on the home front. In December voters narrowly rejected his proposal to rewrite Venezuela's 1999 constitution along "socialist" lines and include a measure that would provide for the indefinite re-election of the president. It was Mr Chávez's first significant electoral defeat after nearly a decade in power. Since then, he has sought to reintroduce elements of the rejected constitution, in part by using a far-reaching enabling law, passed last year, to legislate by decree.

But Venezuelan society has proven remarkably resistant. Teachers, parents and students have blocked the introduction of a politically inspired school curriculum and the abolition of university-entrance

requirements. The private media forced a retreat on attempts to charge them exorbitant fees for material from a state-owned television channel. And a decree setting up a new intelligence-system, dubbed the “Gestapo law”, was repealed on June 10th, less than a fortnight after its introduction, following an outcry from human-rights groups. This would have obliged people to co-operate with intelligence agencies or face up to six years in jail.

Were Mr Chávez the all-powerful dictator some of his critics paint him as, he might well have ignored the protests. But despite his past as a failed coup-leader, he is constrained by the need to operate within the bounds of a democracy, albeit an imperfect one. On November 23rd he will face a fresh electoral test, when the country votes for new state governors and mayors.

Amidst an economic slowdown, annual inflation of around 30% and an unprecedented crime-wave, his prospects of avoiding another humiliating defeat look slim. A new drubbing at the polls would be likely to dash any hope of reviving his plan to evade the constitutional ban on his re-election in 2012. A reaffirmation of the expiry date of his presidency would, in its turn, fire the starting gun of the race to succeed him, thereby further undermining his authority.

Some pundits argue that the recent spate of U-turns simply reflects a populist president's desire to avoid alienating the electorate. The more conspiratorially minded believe that the introduction of unpalatable measures, followed by partial retreats, is a deliberate strategy. They suggest that Mr Chávez is seeking to unsettle the political climate to such an extent that he retains the option to suspend the November elections if the polls look adverse.

A simpler reason for Mr Chávez's many U-turns may be that he has a habit of making policy mistakes, which then require correction. A few months ago, for example, the government announced a series of measures to prevent the economy from overheating. But it overdid the course-correction. In the first quarter of this year, the annual growth rate slowed by around four points, to 4.8%, in comparison with the same period last year. On June 11th, in yet another about-turn, the president announced that some of the measures in the original package would be reversed.

Still, amid all the tactical confusion, Mr Chávez does not appear to have lost sight of his two main strategic goals: the installation of a “socialist revolution” in Venezuela and his own indefinite re-election. After his defeat in the December referendum, a huge billboard went up on a building not far from the presidential palace. “*Por ahora*” (“For now”), it read.

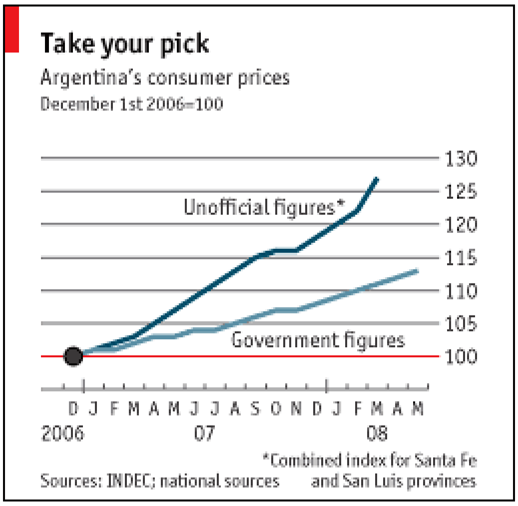
That should be a warning. His foes have learnt the hard way that it is dangerous to underestimate Mr Chávez. He is fond of citing the battle of Santa Inés, in the war for independence from Spain, when a feigned retreat led to victory. As November's election approaches, he is working hard to make sure that he holds on to as many as possible of the 20 states (out of a total of 24) that are currently in *chavista* hands. He has repeatedly told his followers that if important states were to fall to the opposition, his own future would be in doubt—even going so far as to suggest that in such an event “there would be war”. It is too soon to count him out.

Argentina's way with sums

Hocus-pocus

Jun 12th 2008 | BUENOS AIRES
From The Economist print edition

The real-world consequences of producing unreal inflation numbers



RISING inflation is causing headaches for central bankers across the world. But it seems that Argentina's monetary policymakers will be spared such concerns, thanks to the country's updated consumer price index, which came into force on June 10th. According to the new methodology, every time a product's price rises too sharply, it will simply be removed from the index on the ground that consumers will be deterred by the expense and switch to other goods. It came as little surprise, therefore, when the government announced the official inflation figure for May to be a mere 0.6%, while virtually all independent estimates topped 1%.

Argentines are accustomed to their government cooking the books. Since January 2007, the official inflation rate has been doctored to remain in single digits, while the true figure has soared above 20%. When Cristina Fernández de Kirchner succeeded her husband as president last December, it was hoped that she might help restore the government's computational credibility, given that she had promised during her campaign to revamp the national statistics bureau. Those expectations have now been dashed. Rather than stopping the meddling that took place during Néstor Kirchner's administration, the new index merely formalises it.

Even without the government's creative accounting, inflation would still be Argentines' prime concern. Thanks to a public spending binge ahead of last October's elections, along with government-mandated wage increases, a cheap currency and low interest rates, demand has charged ahead of the economy's productive capacity. Most forecasters expect prices to rise by 25-30% this year. Salaries are struggling to keep up, particularly for workers paid under the table. According to Ernesto Kritz, a labour economist, real wages are now stagnant at best, and poverty and income inequality are on the rise. This has caused Ms Fernández's popularity to fall even faster than inflation has risen, from 54% in February to 26% now, according to Poliarquía, a pollster.

But manipulating the official statistics has created costs of its own. Corporate expansion plans and bank lending depend on a reliable benchmark of price increases. In its absence, the long-term investment required to alleviate inflationary pressures has foundered. And although Eric Ritondale, senior economist with EconViews, a consultancy, reckons that the government saved around $500m last year on its inflation-protected bonds as a result of fiddling its figures, investors have punished Argentina for its malfeasance by increasing its risk premium, forcing it to pay higher interest rates when it refinances debt.

Fixing this mess will not be easy. The Kirchners are loth to recognise mistakes, and a legitimate recalibration of the index would require them to admit they have been deceiving the public. A serious effort to combat inflation would also entail implementing policies they have publicly denounced: reducing transport and energy subsidies, raising utility tariffs, increasing interest rates, appreciating the currency and keeping a lid on wages. But the longer they wait to come clean, the fresher their deceit will be in the minds of voters in next year's mid-term elections.

Cuba

High-speed escape

Jun 12th 2008 | MIAMI
From The Economist print edition

Greater optimism at home has not stopped the exodus to the United States

WITH Fidel Castro formally out of office and some signs of greater optimism among Cuba's citizens about the possibility of social and economic change, you might expect fewer people to risk their lives by seeking to escape the island by sea.

Not so, apparently. The number of Cubans trying to smuggle their way into America is the highest it has been for more than a decade. The United States Coast Guard says that over the past eight months 3,846 Cubans have made the trip—a 7.5% increase on last year's already high figure for the same period. Of these, around 40% (1,577) were intercepted at sea, an increase of more than a quarter. In the whole of the last (American) financial year, ending in September, 7,693 sought to flee to the United States, more than half of whom managed to avoid detection. But 3,197 were intercepted at sea, the highest number since the “rafter crisis” of 1994, when 37,000 were caught.

“There is sort of a silent exodus taking place from Cuba,” says Ramón Saul Sánchez, leader of Democracy Movement, a Miami-based Cuban advocacy group. Despite the transition of power from Fidel Castro to his brother, Raúl, many Cubans have little expectation of big changes on the island. American restrictions on travel and remittances to Cuba have added to their sense of desperation.

Yet the spike in the number of Cubans seeking to leave may have as much to do with an increase in organised smuggling as with economic despair. In the past, Cubans made the crossing—just over 100 miles (160km) between Havana and Key West—in home-made rafts. These days, they travel in speed boats hired in Miami by relatives paying up to $10,000 a head for the trip.

Cubans have also discovered a new route to freedom, crossing the sea to Mexico's Yucatan peninsula, then making their way overland to the border with the United States. Under American law, these so-called “wet-foot, dry-foot” Cubans are allowed to stay if they make it to their objective. Those picked up at sea are nearly always repatriated.

Until recently, the trafficking of people was virtually ignored by American officials. But prosecutors in Miami have now begun to get tough. Over the past two months, 41 Cuban-Americans have been charged with attempting to smuggle hundreds of Cubans into Florida by boat. Investigators started to pay greater attention after several drownings cast an ugly spotlight on the trade. The Coast Guard says that 36 Cubans died at sea in April alone. In one incident last November, as many as 40 people from a single village in Cuba, including a dozen children, are believed to have died. Rear-Admiral David Kunkel, the Coast Guard's district commander, recently appealed to Cuban exiles to “put the criminals who engage in human smuggling out of business by not using them”.

In an attempt to stem the flow, America's State Department has accelerated its visa procedures for Cubans seeking to be reunited legally with their families in the United States. But the escalation in smuggling has had one positive outcome: American and Cuban coast-guard officials are now co-operating to try to stop the trade—one of the very few areas where the two countries do work together. “It really is in no one's interest to let this continue,” said one American official.

Aboriginals in Canada

Finding their voice

Jun 12th 2008 | OTTAWA
From The Economist print edition

Canada delivers an official apology to its increasingly assertive indigenous peoples

FEW would dispute that Canada's shameful treatment of many of its aboriginals has left a stain on its image. Between 1870 and 1996, an estimated 150,000 indigenous children were wrenched from their homes and sent to Christian boarding schools, where many were sexually and physically abused. Yet until Stephen Harper, Canada's Conservative prime minister, rose in the House of Commons on June 11th to deliver an unqualified official apology to assembled leaders of Canada's 1m First Nation, Inuit and mixed-race Métis people, no Canadian leader had taken this step.

Parallels will be drawn with a similar act of contrition by Kevin Rudd, Australia's Labor prime minister in February. But the two differ in important respects. Australia offered an apology, but no compensation, to 55,000 mixed-race children forced into white foster homes. Mr Harper's apology follows a C$2 billion ($2 billion) settlement in 2005 of a lawsuit by former students of schools set up, in Mr Harper's words, “to kill the Indian in the child” by assimilating them into the dominant culture.

Mr Harper's decision to apologise now is probably aimed in part at curtailing future lawsuits by Indian victims of abuse, who chose not to take part in the earlier settlement. But it is also shows that he understands the value of saying sorry when the state has harmed its citizens. He recently apologised to Maher Arar, a Canadian tortured in Syria after wrongly being identified as a terrorist; and to Chinese-Canadians for the government's punitive Chinese head-tax policy of 1885-1923.

But this week's ceremony is also testimony to the increasingly sophisticated use made by Canada's indigenous tribes, who make up a mere 3.8% of the population, of the courts, alliances with environmental groups and targeted protests against mining companies to strengthen their otherwise limited influence.

This communications savvy was on display in Prince Albert, Saskatchewan, on May 29th, when the premiers of the four, resource-rich western provinces decided to interrupt their annual summit to participate in a “national day of action” called by the First Nations, many in traditional feathered head-dress. Intended as a “we-share-your-pain” gesture beloved by politicians, it backfired when Chief Albert Mercredi took advantage of the assembled media to denounce the premiers for allowing mining development to pollute the aboriginals' air, land and water. The chief, whose own band lives on Lake Athabasca, downstream and downwind from massive tar-sands operations in Alberta, says the recent arrival of the internet in isolated communities allows them to keep track of the outside world's ideas and deeds.

Informal alliances with environmental groups, adept at using the media to generate political pressure, give aboriginal groups allies in the land-use disputes they once fought on their own. Their ends may differ—greens seized on the oily death of 500 ducks in an Alberta tailing pond last April to promote wildlife safeguards, while the native group downstream regarded the threat to human health as the salient point—but they help each other generate publicity. Tensions do arise, however. Whereas green groups tend to oppose any development, aboriginals are keen on job creation—so long as they are consulted about sustainable projects.

High mineral prices offer native Canadians living in the remote areas where most such resources are found another way to raise their profile. A well-targeted protest that raises corporate hackles—such as the one over a proposed platinum mine in northern Ontario that led to the arrest and imprisonment of six members of the Kitchenuhmaykoosib Inninuwug band—can produce a quicker political response than years of patient negotiations. Ontario's premier now says he will change mining law to ensure that aboriginals are consulted in advance of any mining on their land. Across Canada, other groups are using similar tactics against a wide array of pipeline and mining projects, confident that pressure from frustrated companies will force politicians to take notice.

Although native Canadians may be speaking more loudly, they do not yet do so with one voice. No single group represents them all, which is one reason why there are no co-ordinated proposals to improve aboriginal living conditions, education and financial prospects, which still trail national averages by a wide margin. Still, with the Vancouver Winter Olympics in 2010 providing a golden opportunity for protest, the First Nations, Inuit and Métis have time to hone their already sharp skills in getting out their message.

Populist politics in China

Why Grandpa Wen has to care

Jun 12th 2008 | BEIJING
From The Economist print edition

Despite not having to face elections, China's Communist Party wants to be liked. Nothing wrong with that: but populism does bring some dangers

Reuters

HE SCRAMBLES through earthquake debris, he weeps, he hugs children. If China's Communist Party allowed popularity polls, the prime minister, Wen Jiabao, would probably do better than any politician since the days Red Guard fanatics swarmed to Tiananmen Square for a glimpse of their idol, Mao Zedong. Some who suffered in last month's disastrous earthquake in Sichuan grumble, but party leaders are making political gains.

The cult of “Grandpa” Wen has been helped along by the kind of media-manipulation skills honed in Mao's day. State television broadcasts endless footage of him in the earthquake zone, wearing trainers, ordering troops through a megaphone and comforting victims. But Mr Wen has shown some of the public-relations flair of Western politicians too: calling an impromptu news conference amid swirling helicopters and inviting foreign reporters, who normally have just one chance a year to quiz him, to shout out questions.

The state-controlled press has even enthused about Mr Wen's following on Facebook, a social-networking internet site based in America. *Xinhua*, the news agency, said a page claiming to be his (its real authorship is unknown) showed him the sixth-most-popular politician listed. At the time of going to press Mr Wen was the only non-American among the top ten.

Mr Wen has always delighted in an officially fostered man-of-the-people image. In January he was shown on state television apologising (an act that Chinese leaders usually abhor) to victims of snow-storms that paralysed large areas of the south. Chairman Mao's radical colleagues, if not Mao himself, envied the popularity of the then prime minister, Zhou Enlai, and made Zhou suffer for it. But the present party leader and president, Hu Jintao, has shown no sign of resenting Mr Wen, whose standing is more likely to strengthen the party's grip on power than challenge anyone's authority.

The party needs all the support it can get. Inflation is causing widespread public anxiety. Urban and rural protests have been increasing in recent years, fuelled by official wrongdoing such as corruption and land grabs. Parents of children killed in Sichuan when their shoddily built schools collapsed in the earthquake have been denouncing local officialdom, which has responded by trying to silence them.

But some Chinese worry that the party's efforts to boost its standing among the downtrodden, as well as

to pander to rising nationalism, reflect a trend towards populism. The party was quick to side with nationalists who lashed out at the West in the wake of unrest in Tibetan areas in March. To its relief the earthquake helped defuse some of this anger, which was threatening to overshadow the Beijing Olympics in August. But the party still bends in the wind. Late last month officials agreed that Japanese military aircraft would bring relief materials to Sichuan. China changed its mind after vituperative outbursts online by nationalists, still angry with Japan for its occupation of China in the 1930s and 1940s. The material was sent by civilian aircraft instead.

In recent weeks some Chinese intellectuals as well as official newspapers have engaged in heated debate about the dangers of populism. In April *China Youth Daily*, a Beijing newspaper, published an article describing China's internet-savvy nationalists as “online Red Guards” infected by a “populist virus”. This virus, it said, had had a serious impact on China's intelligentsia. Common symptoms, it said, included anti-Western, anti-democratic, anti-reform and anti-market thinking along with a love of Mao, the former Soviet Union and today's Russia. In countries with poorly developed market economies and undemocratic systems, it noted, populism was more likely to act like “dynamite”. Its explosion could produce “despots or violent upheaval”.

The author was Wu Jiaxiang, a researcher in a pro-reform think-tank with close links to the government. Mr Wu, ironically, writes admiringly on his blog of Wen Jiabao's common touch. In the 1980s he accompanied Mr Wen, then in charge of the party Central Committee's day-to-day work, on a provincial trip. Even then Mr Wen ate simply and wore an army greatcoat, which Mr Wu noticed years later on television he was still wearing.

However, in an interview, Mr Wu worried that some recent developments in China suggested a populist lurch. They include a labour-contract law that came into effect on January 1st and which many employers fear could make it much harder to fire underperforming workers. He also noted the promotion in March of several descendants of revolutionary elders (including one of Mao's grandsons) to positions as advisers to the legislature. On June 10th an article in *Study Times*, a pro-reform newspaper published by the party's training centre for senior officials, gave warning that “populist” measures to narrow the country's growing gap between China's rich and poor could damage its economic performance.

No one in China describes himself as a populist, but many rail against populism's critics. *China Youth Daily* has aired the views of both camps. On June 3rd it published an article that spoke of “antagonism increasing by the day between the masses and China's elite” (meaning, apparently, the intelligentsia). The author raised the case of “Runaway Fan”, a teacher in the earthquake zone now notorious for fleeing a school building ahead of his pupils. Were the “elite”, like Mr Fan, the author asked, paying too much attention to themselves and not enough to the masses?

China's leaders certainly do pay them attention. The Sichuan earthquake has created millions of potential malcontents. Mr Wen's efforts have impressed many for now. But it will take sustained efforts and huge spending over many years to keep them satisfied. To ease the agony of the thousands who have lost the only children government policy allowed them to bear, doctors are to provide free treatment to reverse sterilisation procedures. A little populism can be a mercy.

China and Taiwan

Strait talking again

Jun 12th 2008 | BEIJING AND TAIPEI
From The Economist print edition

Picking up where they left off in 1999

THE previous attempt by China and Taiwan to end their decades of official acrimony ended in a mutual huff. But now they are talking to each other again as if nothing had happened. At their first formal negotiations in nearly a decade, which began in Beijing on June 12th, the two sides are ignoring political differences and focusing on air services and tourism.

The two teams appeared on track to sign an agreement on June 14th that would allow Chinese tourists to visit Taiwan without, as at present, having to go through third countries (visitors to the Taiwan-controlled outlying islands of Kinmen and Matsu can already go directly). The new tourism arrangement is expected to start in July, along with the launch of weekend charter passenger flights. On their first day of talks, the two sides agreed to set up representative offices to handle visas in each other's territories.

Talks between China and Taiwan have always been couched in coded language, to gloss over their opposing views of Taiwan's status. The negotiators are from organisations whose think-tank-style titles are meant to camouflage their official identities. (In China's view there is no Taiwan government, just an uppity local authority.) China broke off talks in 1999 because of Taiwan's decision to end the pretence and call for country-to-country ties. The election in 2000 of a president, Chen Shui-bian, whose Democratic Progressive Party (DPP) was implacably opposed to any hint of overlapping sovereignties, made China dig its heels in further.

But since the inauguration in May of a new president, Ma Ying-jeou of the China-leaning Kuomintang party (KMT), ambiguity has been back in vogue. The two sides have agreed to talk on the basis of what they call the “1992 consensus”. This formula agrees that there is “one China” but reserves each side's right to define this in its own way. This pleases China immensely but is politically more sensitive in Taiwan. The KMT soundly defeated the DPP in the presidential elections in March and in legislative polls in January, but suspicion of China remains widespread.

Mr Ma is calculating that the economic benefits of a flood of Chinese tourists to the island will help allay such fears. He aims to receive 3,000 a day, which would be a useful boost to Taiwan's lacklustre economy. Critics, however, say that his rush to attract China's big spenders is giving Beijing the upper hand at the negotiating table. Taiwan has quietly swallowed China's refusal to allow an early launch of charter cargo flights. China, it is thought, wants to protect its air-cargo industry from Taiwanese competition.

Taiwanese officials have shown their sensitivity to public opinion. Earlier this month the Ministry of Foreign Affairs instructed its overseas offices not to use the word Taiwan in official documents to avoid upsetting China. Instead they were to use the island's official name, Republic of China. But the ministry quickly backtracked amid a political uproar.

Teaching in English in Hong Kong

The cat got your mother tongue?

Jun 12th 2008 | HONG KONG
From The Economist print edition

The Brits make a linguistic comeback

IT WAS an admission of cultural defeat; but then Hong Kong is nothing if not pragmatic about such things. On June 6th its education minister, Michael Suen Ming-yeung, lifted restrictions that forced four-fifths of the territory's more than 500 secondary schools to teach in the “mother tongue”, ie, Cantonese, the main language of its residents and of southern China. Schools may switch to English, the language of the former colonial oppressor, from next year.

This reverses a decade-old policy adopted after Hong Kong's reversion to China in 1997, in an assertion of independence from both former and present sovereign powers. Emotion may have played a large role in the decision. But it made some sense. Students speak Cantonese at home, and so using it is the easiest way to impart information and promote discussion. It is also the first language of most teachers: a study done at the time concluded that schools labelled “English-medium” were actually teaching in Cantonese but using English-language textbooks (with predictably chaotic results).

After much bureaucratic shuffling, 20% of schools were permitted to continue teaching in English. That may have made sense to teachers and administrators, but not to ambitious parents. They know that their offspring will need English to get ahead. Those who could flee the public system for costly private schools, or for the eight semi-private schools run on the British system, did so. The rest made extraordinary efforts to enter the minority of English-language schools. They have huge waiting lists; Cantonese ones gaping holes.

That helps explain Mr Suen's change of heart, for which no reason was given. So does a survey published last year, which concluded that students from the Cantonese schools did far worse than their peers in getting into universities—a result that would horrify Hong Kong's achievement-obsessed parents. And whatever the educators think, employers from coffee bars to banks either require people to be bilingual or pay more to those who are. Private schools offering supplementary English tuition have mushroomed.

Hong Kong's slow-moving educational bureaucracy has devoted much thought to how English could be offered without harming other studies, and without sacrificing a generation of teachers with a vested interest in a system based on their first language. Mr Suen has skirted these difficult issues. A much-debated but still undisclosed formula will allow an increasing number of subjects to be taught in English. Every step is controversial. As China's most global city, Hong Kong needs skills in both English and Mandarin, or *putonghua*, China's common language. Pragmatists want Hong Kong to drop Cantonese entirely in favour of the two more broadly used languages. But that may demand a level of cultural indifference which even Hong Kong cannot muster.

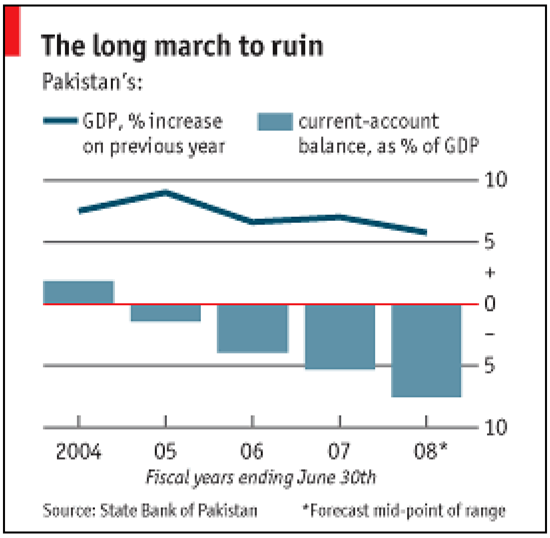
Pakistan's economy

Stopping the rot

Jun 12th 2008 | LAHORE
From The Economist print edition

Just like the bad old days

BRIGHTLY painted Tata lorries, laden with sacks of onions, wait in the noon heat at the Wagah border post between India and Pakistan. Once past customs, the onions will go on to Lahore and beyond. But the lorries must turn back. Their produce is laboriously loaded onto smaller vans, driven by locals.



Pakistan's costly imports of food ($3.5 billion in the first ten months of this fiscal year, which ends on June 30th), fertiliser ($823m) and fuel (over $8.6 billion) may pull the economic rug from under its newly installed government, which presented its first budget, belatedly, on June 11th. The State Bank of Pakistan (SBP), the central bank, reckons the country's current-account deficit might reach 7.8% of GDP this fiscal year, its highest ever (see chart). Growth has slowed to 5.8%, inflation has quickened to over 19% and the government's budget deficit, at about 7% of GDP, is the highest in ten years.

Such macroeconomic disarray will be familiar to the coalition government led by the Pakistan People's Party of Asif Zardari, and to Nawaz Sharif, whose party provides it “outside support”. Before Mr Sharif was ousted in 1999, the two parties had presided over a decade of corruption and mismanagement. But since then, as the IMF remarked in a report in January, there has been a transformation. Pakistan attracted over $5 billion in foreign direct investment in the 2006-07 fiscal year, ten times the figure of 2000-01. The government's debt fell from 68% of GDP in 2003-04 to less than 55% in 2006-07, and its foreign-exchange reserves reached $16.4 billion as recently as in October.

But in the months since, the turnaround economy has threatened to turn full circle. The political turmoil that followed President Pervez Musharraf's imposition of a state of emergency in November and Benazir Bhutto's assassination in December is not wholly to blame. Pricey fertiliser and April hailstorms hurt the wheat harvest. The mealy bug and other afflictions cost about 16% of the cotton crop, which in turn hurt the textile industry. And over 27% of Pakistan's higher import bill was due to the spike in oil prices alone.

But all this made it a bad moment for Pakistan to spook foreign investors with its wobbly politics. They bought just $97m-worth of shares in the first ten months of this fiscal year, compared with over $1.5 billion in the same period a year earlier. Reluctant to test the foreigners' appetite for its securities, the government has turned to the charity of multilateral lenders and friendly governments. Pakistan also received over $5.3 billion in remittances from migrant workers in the ten months to April, half of it from the Gulf.

Mr Zardari has recently returned from a pilgrimage-cum-begging mission in Saudi Arabia. The Kingdom reportedly agreed to defer charges on some of the 250,000 barrels of oil it sells Pakistan each year. This forbearance comes on top of a $300m handout to the government.

What will his government do with this money? Its new budget aims to narrow its fiscal deficit to 4.7% of GDP, based on an optimistic forecast of revenues. It will raise sales taxes across the board and impose heavy duties on luxury items such as perfume and chocolate. It has resolved to “prune” the “unbearable” subsidies, mostly of fuel and electricity, which now consume one-fifth of its budget, promising instead to give poor households 1,000 rupees ($15) a month in cash. The scheme will be named the “Benazir programme”, lest the beneficiaries forget which party to thank. The budget's allocation to the army was less in real terms than it was last year. But even as it spends less on guns, it promises to spend more on soldiers, raising their pay by 20% along with that of every other federal employee. Other expenses on the bureaucracy, however, are to be frozen: civil servants will have to forgo their new cars and air-conditioners.

As the finance minister unveiled his plans, Pakistan's lawyers began their “long march” to Islamabad, demanding Mr Musharraf's removal and the reinstatement of the senior judges he sacked last year. On June 7th Mr Musharraf told the press that he was not about to leave his post or the country. He will know when to quit, he said. He will not sit around like a useless vegetable, or like the onions waiting to cross the border at Wagah.

Japan

Yasuo Fukuda's Lazarus moment

Jun 12th 2008 | TOKYO
From The Economist print edition

A grey man tries to show his gumption

Reuters

Looking up for Fukuda?

IT HAS, says the ruling coalition's exhausted parliamentary chief, Tadamori Oshima, been a bruising battle. And hardly beautiful: the six-month session of Japan's Diet (parliament) that is coming to a close has pitted the governing coalition led by the Liberal Democratic Party (LDP)—dissipated after a half-century in power and bereft of fresh ideas—against the opposition Democratic Party of Japan (DPJ), newly empowered by its control of the Diet's upper house, eager to pick fights with the government, but still far from proving itself capable of actually governing. The censure motion passed against the government on June 11th—the first ever against a government by the upper house—ensured that the session ends on a sour note. The motion was passed out of spite, not principle, and reflects poorly on both camps.

If the battle has any winner, strangely, it is Yasuo Fukuda, the 71-year-old prime minister. This is not obvious from his popularity. The cabinet's approval ratings have risen slightly, but they are still abysmal, below levels at which previous prime ministers have resigned. Nor is it obvious from local elections on June 8th for Okinawa's prefectural assembly, in which the ruling coalition lost power. Voters seemed angry, especially about uncertainty over pensions, and about an ill-judged system implemented in April making health care costlier for the elderly.

Rather, Mr Fukuda appears for now to have won back control of a political agenda that had been seized by the DPJ from the instant he came to office in September. He has done this, procedurally, by using the coalition's supermajority in the lower house in order to ram through legislation opposed by the upper house. But mainly he has thrown the opposition off-balance by seeming to agree with its leader, Ichiro Ozawa, that the LDP is a party of reaction and narrow interests.

Mr Ozawa hoped in the spring to bring down the government by going for the LDP's pork-barrel interests, in particular a slew of earmarked taxes that feed an ugly road-building programme worth ¥59 trillion ($550 billion) over ten years. In response, Mr Fukuda promised to revamp the programme and to scrap earmarked taxes. When Mr Ozawa said that the coalition's plans to lessen the baneful influence of the bureaucracy did not go far enough, Mr Fukuda duly instructed his government to incorporate the DPJ's proposals into its bill. Countless attributes mark Mr Fukuda—by temperament, dry, cautious and cynical—from Junichiro Koizumi, Japan's dashing and reformist prime minister in 2001-06, whom Mr Fukuda served as chief cabinet secretary. Still, Mr Fukuda has pulled off a Koizumi-like feat: with Mr Ozawa's help, he has positioned himself as a crusader against his own party's forces of reaction.

Mr Fukuda has promised the public some very bold things, to be dealt with in a special session of the Diet running from late August until perhaps early next year. Not even Mr Koizumi managed to defeat Japan's rotten “construction state”. Yet Mr Fukuda has chosen to tackle road-building issues within the context of sweeping tax reforms designed to set the state's shaky finances on a sounder footing as Japan's population both shrinks and ages.

This will entail a steep rise, presumably in stages, of the consumption (sales) tax—a delicate political matter. On July 1st the LDP's tax committee meets to begin hammering out the details. The chief lines of debate will be drawn between Kaoru Yosano, a former economy minister who argues for a swift start to hikes in the consumption tax, and Hidenao Nakagawa, once a close adviser to Mr Koizumi, who says the bureaucracy must be fixed and supply-side measures taken first.

Over the summer, it will become a little clearer whether Mr Fukuda has the gumption to push his agenda. Much depends on his public standing—or perhaps on the big media groups who claim to speak for the public and who have not yet called for his head. The prime minister appears to expect that by playing host to the G8 summit in July, which is likely to focus on climate change and on the rising price of food and fuel, his popularity will recover.

This week Mr Fukuda set out his stall as grey man turned green, promising a “low-carbon revolution”. He called for Japan to cut its greenhouse-gas emissions by up to 80% by 2050. This may bolster his credentials as the summit's host, but not do much for his domestic standing. Soon after the summit, Mr Oshima expects, Mr Fukuda will shuffle his cabinet, whose members were largely inherited from Shinzo Abe, his hapless predecessor. Whether he replaces them with “quiet revolutionaries”, as Mr Nakagawa puts it (including presumably himself), or instead rewards each party faction with a Buggins' turn will give a strong sense of Mr Fukuda's resolve.

For now, colleagues—many critical just weeks ago—give him the benefit of the doubt, and say his mood is ebullient. One senior LDP member, called in to discuss the party's future, says he nearly fell off his chair when Mr Fukuda proposed transforming the LDP, traditionally the party of business, into the party of the environment. Mr Fukuda has also promised to promote the interests of consumers.

Yoriko Kawaguchi, a former foreign minister, says that Mr Fukuda was forced at first to grapple with inherited problems, but is now able to follow his own path. But she adds that any number of dangers—public disaffection, government scandal, a worsening economy, or a ruthless opposition—could yet mug him. Mr Oshima predicts that Mr Fukuda will now survive until an election must be called in September 2009. Beyond that, few ruling politicians want to ponder their party's future. For a prime minister thrown into Japan's current political mess, in other words, success is measured in months, not years.

Friendless fire

Jun 12th 2008 | LAHORE
From The Economist print edition

An alliance under strain

MANY Americans fondly believe it is only diplomatic tact that restrains them from surgical strikes against their enemies in Pakistan to prosecute the "war on terror". But on the night of June 10th, the bloody complications of such forays became starkly apparent. American-led NATO forces, based in Afghanistan, mistakenly killed at least 11 Pakistani paramilitaries in an airstrike across the border.

The killings took place in the Mohmand area of Pakistan, a no-man's-land, where one country bleeds into the other. It is in a part of Pakistan called the Federally Administered Tribal Areas—a name that is more of an aspiration than a description. The Pakistani army has withdrawn from large parts of the area, leaving lonely border posts manned by paramilitaries called the Frontier Corps.

The trouble started when the Afghan National Army tried to set up a border post in Mohmand. They were dissuaded by the Mohmand Rifles, a detachment of the Frontier Corps. As the Afghan forces retreated, they came under attack from the Taliban. The NATO airstrikes they called in failed to distinguish between the Taliban and the Mohmand Rifles, who wear the same garb, a *salwar kameez*, as their militant rivals. The final death toll is not yet known. A number of riflemen are missing.

The Frontier Corps and the Taliban share more than a dress code. They belong to the same Pushtun ethnic group, which populates both sides of the border, and their distaste for the Americans differs only in degree, not kind. The killing of their comrades will sow further disaffection. It was not the first time American-led NATO forces have fired missiles across the border, but it was the first time so many Pakistanis had been killed.

The Americans were quick to defend the strike as a legitimate act of self-defence. They have released a video to bolster their case. But Pakistan's prime minister denounced the attack as an affront to the country's "sovereignty, dignity and self-respect". It "hit at the very basis of co-operation and sacrifice with which Pakistani soldiers are supporting the coalition in the war against terror", a military spokesman said, denouncing the act as "absolutely unprovoked and cowardly".

Co-operation is anyway not what it was. Since President Pervez Musharraf was sidelined by Pakistan's February elections, the Americans do not know whom to call on to help orchestrate their fight in these nettlesome border regions. The Pakistani army, which always had mixed feelings about pummelling their erstwhile Taliban allies, has been only too happy for the civilian politicians in the new government to carry the can for the war on terror. But that government, an unsteady coalition, is itself unsure of how to proceed. It must square the demands of Pakistan's regional governments, the army, the Americans and its own voters.

In the borderlands, a rough-and-ready pragmatism reigns. The Frontier Corps will strike local truces with the Taliban, which may or may not leave the militants free to attack other targets. Unsurprisingly, the corpsmen are more interested in staying alive than prosecuting America's war aims. Sadly for the men of the Mohmand Rifles, such on-the-ground diplomacy offers little protection from the air.

South Korea

Ill met by candlelight

Jun 12th 2008 | SEOUL
From The Economist print edition

Ministerial resignations may not be enough to save the president

THE huge candlelit demonstration in Seoul on the evening of Tuesday June 10th was a sight to behold. Some 700,000 protesters were crammed together, hemmed in by shipping containers dumped onto the streets and by police buses. The authorities said they feared violence. In particular they wanted to prevent the crowd from marching on the office of the president, Lee Myung-bak. Since the crowd included mothers with babies, Catholic nuns, pensioners, and schoolgirls prim in their uniforms, it seemed unlikely to turn into a Molotov-cocktail throwing mob. A Buddhist monk held aloft one of many signs calling on Mr Lee to resign. But on the 21st anniversary of a protest that helped topple the dictatorship of Chun Doo-hwan, Mr Lee was taking no chances.

Just hours before, the prime minister, Han Seung-soo, and all 15 cabinet ministers offered to resign. So had nine of Mr Lee's senior aides. The president's office hints that he may accept six ministerial resignations, including Mr Han's, and the foreign and agriculture ministers'.

Mr Lee is seeking to placate a public angered by the government's decision in April to resume beef imports from America, stopped in 2003 after mad-cow disease was found in American cattle. South Koreans, who eat almost all parts of a cow, fear that American beef is still unsafe. Mr Lee and the American ambassador to South Korea have imperiously dismissed such concerns. A restive public suspects that the two countries' free-trade agreement is being placed above its health concerns. Few were impressed by the resignations.

Mr Lee has little room for manoeuvre. Any serious attempt to rewrite the trade deal will upset America. At a meeting in Washington this week, South Korean officials sought assurances that America would not send beef from cattle older than 30 months (believed to be a greater health risk). But the American administration said it would not renegotiate. If so, Mr Lee will face increasing isolation at home and may become a lightning rod for mounting dissatisfaction about rising prices and unemployment. This month the president's Grand National Party suffered a precipitous drop in support in local elections.

Without popular backing, Mr Lee's ambitious legislative agenda of privatisation and cuts in tax and spending is unlikely to be passed by parliament. The nightly protests are now as much about Mr Lee as they are about mad cows. To regain public trust the president, a proud man who has risen from poverty, may need to show a softer touch. He does not have much time.

Kazakhstan

Capital idea for a present

Jun 12th 2008 | ALMATY
From The Economist print edition

Aw shucks, you shouldn't have...I couldn't possibly accept

Illustration by Claudio Munoz

WHAT do you give a man who has everything, or at least the seemingly permanent presidency of a big Central Asian republic? You rename its capital in his honour, of course. That is how Sat Tokpakbayev, a member of the one-party parliament and former Kazakhstani defence minister, wanted to mark the 68th birthday next month of President Nursultan Nazarbayev.

In suggesting in parliament that Astana change its name to “Nursultan”, Mr Tokpakbayev achieved the near-impossible: distinguishing himself for sycophancy from the mass of other well-wishers, not least those in parliament. His proposal was at once enthusiastically endorsed by an estimated 90% of the deputies. (The others, all also members of the president's party, Nur-Otan, must be ruing their absence that day.)

Mr Tokpakbayev and his supporters point to precedents. Russia has St Petersburg, named after Peter the Great's patron saint, America has Washington, neighbouring Turkmenistan has the Caspian port of Turkmenbashi, named for its late dictator. But Kazakhstan's opposition newspapers scoffed. *Respublika*, a weekly, recommended that the circus clowns take a holiday so the parliamentarians could take their place.

With Kazakhstan facing an economic slowdown and galloping inflation, many observers wondered whether parliament might not find more urgent topics to discuss. But Mr Nazarbayev has turned down parliament's petition. “The decision to change the name will be made by another generation,” he said. This has given rise to speculation that the suggestion was merely intended to burnish the image of a man not known for self-effacing modesty.

Be that as it may, Astana, which will celebrate its tenth anniversary as Kazakhstan's capital next month, is used to name changes. It has been called Akmolinsk, Tselinograd and Akmola. Mr Nazarbayev himself renamed it Astana (“capital”). A more fitting gift might have been to rename the presidency: the “Nursultanate”, perhaps?

Ethiopia

Will it ever be able to stave off starvation?

Jun 12th 2008 | HARAR
From The Economist print edition

Reuters

Famine is once again threatening the continent's second-most-populous country and once again its government is partly to blame

Get article background

GORU GUTU is perched in the misty heights of the steep hills above Harar, in eastern Ethiopia. For the poorest, life here is still akin to serfdom—minus a tsarist order. The government owns the land; a banner over its local office proclaims “the people” to be “the base of all development”. Yet labourers get by in Goru Gutu district much as they have always done, tilling soil by hand, digging ditches, doing whatever it takes to buy a few cups of grain to keep their families alive.

This year, however, their efforts have been in vain. The land is green but hailstorms, rains that came too late, then rains that fell too heavily, as well as infestations of insects, have left Goru Gutu starving. As you head deeper into the hills, the animals get thinner, the children more listless. The food in the market is too expensive, and there are no informal sales on the roadside. No one is eating. Where wheat and maize should have been growing in the terraces that slice back and forth along the slopes, there is nothing. The average daily labouring wage, equivalent to 80 American cents, is not enough to survive on.

So it is across much of south and east Ethiopia. In the highlands the rain was erratic; in the lowlands it fell not at all. The result is that an extra 4.5m of Ethiopia's 80m people need emergency food, on top of the 5m or so who already get it, according to the UN's World Food Programme.

The government says a recovery is possible if the rains expected later in the year are good. Foreign aid specialists say that the food shortages are “going in the direction of high mortality”. The government is supposed to have 450,000 tonnes in a grain stockpile, with 100,000 tonnes in reserve to keep prices from rising too much. But it has only 65,000 tonnes left.

If Goru Gutu district is an indicator, things will get far worse; many people will starve to death. Ibsaa Sadiq, a local government official, reckons that nearly half of the 116,000 people who live here, especially women and children, need food aid to survive. A feeding centre run by the government, assisted by Catholic nuns, cares for some 800 of the hungriest children. They spend days or weeks in a metal shed smelling of diesel and disinfectant.

Hindiya, 18 months old, is puffed up by edema, a protein deficiency. Even if she survives, she may suffer mental and physical stunting, heart disorders and a weakened immune system. Her mother, Fatima, gently peels back a dirty cloth to show how the skin along Hindiya's calves and heel has split wide open.

She is in excruciating pain. Her three siblings survive on a bowl of maize-meal porridge a day, with no milk or sugar; no one in the family has ever eaten meat. If she makes a full recovery Hindiya will be sent home with rations, but there is no money for a return visit. “This is a revolving door,” explains an aid worker. “Next time we'll have nothing for these children.”

Because of the failed harvest, more food has to come from outside. Prices have been pushed up by rising fuel costs as well as by scarcity. Potatoes, maize and sorghum cost three times more in the market than they did last year, yet wages have hardly budged. The communal spirit that encourages people to share food, especially when it is scarce, may start to break down. People in Goru Gutu who have buried grain in pits by their huts get at it only by night for fear of begging neighbours.

A famine on the scale of 1984, when Band Aid and Live Aid raised about $150m in relief for Ethiopia, is still unlikely. Logistics and medical understanding have improved. Yet, sadly, some of the conditions that created that famine have not really changed. Ethiopia still has too many people eking out a living on too little land, depending on rains that can never be relied on. Meteorologists say that the problem is not just the amount of rain but the climate's increasing volatility.

The government has also failed. After several good harvests since the last big famine, in 2003, Ethiopia had a chance to progress. Instead, it dithered over reforms to promote private business and overhaul the country's sclerotic banking system and mobile-phone sector. Aside from coffee, qat (a narcotic leaf chewed by Somalis), horticulture and a little tourism, Ethiopia is one of Africa's very few countries that still has virtually no serious private business—and thus few jobs—outside the state sector. Almost three-quarters of the population may be under- or unemployed.

So few families have a chance to save anything for hard times. The lack of wealth creation makes the government more vulnerable to external shocks. The soaring price of oil may cost Ethiopia $1 billion this year—equivalent to its entire foreign-exchange earnings. Meles Zenawi, the prime minister, cannot be blamed for record oil prices or for the rising cost of food worldwide, both of which have sparked riots in several African countries. But he bears some responsibility for failing to increase his country's hard-currency earnings.

His government people point out that new power-generating projects are set to turn Ethiopia into an exporter of electricity. They also point to reductions in infant mortality and say that Ethiopia is achieving several of the UN's Millennium Development Goals. Still, with 80% of its people living off the land, Ethiopia is producing far too little to cope with a possible doubling of its population by 2050.

The government's lack of enthusiasm for private enterprise is matched by its lack of enthusiasm for competition in politics. Mr Zenawi has already splintered the ineffectual opposition parties with the liberal use of torture and imprisonment. A proposed new law on charities would stamp on many groups working to improve human rights and encourage press freedom.

This week the government brushed off allegations of war crimes in the Ogaden region, where it is conducting a ferocious counter-insurgency against an armed separatist group, the Ogaden National Liberation Front. A report by Human Rights Watch, a New York-based monitoring group, says that violence against civilians in Ogaden has risen dramatically since the front's guerrillas slaughtered 70

Chinese and Ethiopian oil workers last year. At least 159 civilians, it says, have been publicly executed, including young girls. The government has banned journalists from visiting the worst-affected areas, but some of the allegations of burning villages have been backed by satellite imagery.

Don't mention the famine

Mr Zenawi is particularly sensitive about famine talk. He has denied that pastoralists in the south are losing livestock to the drought or that the rates of malnutrition elsewhere are at all close to what foreign aid workers claim. The government has banned photographs of the starving and has told field workers not to give information to foreign journalists.

Ethiopia understandably yearns to shed its reputation as the world's poster child for famine. Some foreign agencies do seize crudely on images of emaciated infants to secure extra funding. But the government's attitude comes close to denial; it will not help the people of Goro Gutu.

“The only future is resettlement,” blurts out a local official. Even so, if the population of the district were to stand still, some 4,000 people a year would have to be resettled from Goro Gutu to more fertile land; the government has a budget to shift a few hundred. With its population increasing so fast and farming methods still too basic to sustain it even when the rains are good, Ethiopia's chances of making real progress any time soon look slim.

South Africa

After the storm

Jun 12th 2008 | JOHANNESBURG
From The Economist print edition

Some hard choices for people driven from their homes in the recent violence

Get article background

FOREIGNERS relocated to a camp on the southern fringe of Johannesburg going by the unfortunate name of Rifle Range are angry. Victims of the xenophobic violence that rocked parts of South Africa last month, they were moved last week from police stations where they had taken refuge from homicidal mobs. But the tents and blankets they have been given are not enough to fend off the biting winter cold, there is no hot water, and many are sick. They fear for their safety. So they are demonstrating by holding makeshift cardboard placards, shouting and demanding help from the United Nations.

AP

Taking shelter, still no rainbow

Solange, a 28-year-old Congolese mother of five, fled the war in her home country six years ago for a supposedly more peaceful life in South Africa. But she and her family had to flee again last month, leaving all their belongings behind, when the South African family from whom they rented a room beat up her husband. She says her children have had diarrhoea since they moved to the tented shelter and they no longer go to school, afraid to leave the camp. The recent violence has revived old traumas for those who have fled war and persecution at home. Anxious and feeling trapped, they wonder where to go from here.

Though numbers are hard to come by, South Africa is thought to be home to 3m-5m African migrants, many of whom come from neighbouring countries. In the recent orgy of violence, mainly around Johannesburg and Cape Town, more than 60 people were killed and tens of thousands left homeless and destitute. It appears to have subsided, and more than 1,000 people have been arrested. But now the refugees and the authorities have to work out what to do next.

Some of the victims have already voted with their feet. About 40,000 Mozambicans have gone back to their country, whose government this week lifted a state of emergency it had called to deal with the unexpected inflow. Some Zimbabweans, facing severe political violence and poverty at home, have reluctantly returned home, but others have opted for Zambia or Botswana.

For those who have stayed, the South African government, with the help of the UN, the Red Cross and other charities, has set up temporary camps to relieve the police stations, churches and community halls where people first sought refuge. But the violence took local officials by surprise and they have little experience of this kind of crisis. Camps are not always up to scratch, although things are improving. In the Western Cape, bickering between the provincial authority, which is in the hands of the national ruling party, the African National Congress, and the opposition-run city of Cape Town have made things worse.

Last week about 6,000 people were still in temporary shelters around Johannesburg, from a peak of 20,000.

The government has said that it will provide the camps for only two months, after which people will either have to rebuild their lives in South Africa or go back home. But many feel scared to face the very neighbours who tried to kill them or too frightened to go back to their home countries. Officials are trying to persuade locals to be more welcoming; outfits like the International Organisation for Migration are working with radio stations to spread anti-xenophobic messages. The Institute for Democracy in South Africa, a local think-tank, reports that in poor communities with strong and effective local governments, officials managed to contain the violence.

But in other neighbourhoods, poor South Africans, frustrated by unemployment, soaring food and petrol prices, and feeling forgotten by their government, accuse the foreigners of stealing jobs, houses and other meagre resources. These problems will take a lot longer than two months to resolve.

Congo

It's all relative

Jun 12th 2008 | KINSHASA
From The Economist print edition

Things are better than they were five years ago, but they are still pretty awful

“LAST week, the military situation remained relatively calm across the territory of the Democratic Republic of Congo. Nevertheless, incidents were reported in the Kivus.” This unchanging opening mantra of the weekly press conference held by Congo's UN peacekeeping mission, known by its acronym MONUC, is an exercise in understatement.

Despite the signing in January of a peace deal intended to pacify the country's lawless eastern borderlands near Uganda, Rwanda and Burundi, daily clashes still occur between Tutsi insurgents, local Congolese militias and the Congolese army. More than 500,000 refugees who fled the fighting last year are still afraid to return home, with good reason. Civilians are increasingly the targets of lethal reprisals by all sides. In particular, the conflict has become notorious for the frequent use of rape and sexual violence by all sides as a weapon of war.

But progress in Congo is relative. Just five years ago, it was in the final throes of a war that had sucked in at least half a dozen other African countries and had left much of Congo in ruins after claiming the lives, through disease and displacement as well as fighting, of at least 4m people, the largest such death toll since the second world war. By comparison, today's violence, though menacing, is much reduced.

In 2006 Joseph Kabila became Congo's first democratically elected leader in over four decades in polls that were organised by the UN, and which were reasonably free and fair. But his biggest campaign promise—to stamp out the smouldering embers of the 1998-2003 war—has not been fulfilled at all. The fighting in the two Kivu provinces, which has its roots in neighbouring Rwanda's genocide in 1994, has lasted for more than a decade. And there are worries that a new front is opening in the already complex conflict.

As part of an agreement struck last year with its erstwhile enemy, Rwanda, Congo's government vowed to hunt down and defeat the Democratic Forces for the Liberation of Rwanda (FDLR). This is a movement of Hutu rebels who have been based in eastern Congo since fleeing Rwanda after helping to orchestrate the slaughter there of nearly 1m Tutsis and moderate Hutus in 1994. Clashes involving FDLR fighters are on the rise. There are 70,000 more refugees now in North Kivu than when the peace accord was signed in January. A big offensive against the rebels by Congo's army, as demanded by Rwanda's government,

risks prompting a new bloodbath and pushing an already dire humanitarian crisis out of control.

The UN is hardly in a position to help. In December Mr Kabila sent in 25,000 of his government's forces to suppress General Laurent Nkunda's Tutsi insurgency in the east, which is aimed against the FDLR. But they were routed by a much smaller force of insurgents, about 4,000. Further compromising their role after the UN's Indian peacekeepers in North Kivu had failed to support the Congolese army's advance, as they had been ordered to do, some of those same blue helmets are now being accused of supplying the Hutu rebels, whom Congo's army is meant to suppress, with ammunition in exchange for poached ivory.

If the situation in the east is dire, the rest of Congo is not much better. Mr Kabila's triumph at the polls has long lost its shine. Much of the country has for months been hobbled by strikes over unpaid wages in hospitals, schools and universities. In the south-eastern province of Katanga, Congo's mining heartland, increased foreign investment has not yet produced new jobs. Instead, as throughout Africa, the cost of food and transport has nearly doubled since the beginning of the year. Crime is up too.

Mr Kabila, at least for now, has managed to keep the lid on growing discontent. But to do so he has had to resort to repression and violence, just as his reviled predecessors did. “Why protest? They'll just kill you,” says a market vendor in Kinshasa, the capital, where her business has dwindled as prices soar. “The police will arrest you. We aren't free to protest.” The regular crackdowns on even the smallest and mildest public demonstrations are dampening the hopes of Western governments, which generally wanted Mr Kabila to win the election in 2006, that the vote would usher in a new era of political pluralism, let alone peace.

The opposition, already heavily outnumbered in parliament, is fractured and factionalised. Senator Jean-Pierre Bemba, a former rebel leader who had been the opposition's chief figure and runner-up to Mr Kabila in the presidential poll, had been in exile in Portugal since fighters loyal to him were defeated in three days of gun battles in the streets of Kinshasa more than a year ago. However, last month Mr Bemba was arrested in Belgium on a warrant issued by the International Criminal Court at The Hague, which has accused him of war crimes.

Still, bad as things are, they could be worse, especially when viewed through the prism of the recent past. “Five years ago, no one ever would have believed that we'd ever have elections or institutions,” says a Kinshasa banker. To that modest extent, there has been progress of a kind.

Algeria

Richer but still nervous

Jun 12th 2008 | CAIRO
From The Economist print edition

Algeria should be enjoying its cash windfall more than it is

Get article background

CAN money buy happiness? For Algeria, the answer looks pretty clear. Ten years ago the huge, chronically turbulent but energy-rich country was in the depths of a hideous civil war. Aside from the violence that turned its cities into ghost towns and cost the lives of as many as 200,000 people, Algeria endured massive unemployment and a colossal foreign debt, the servicing of which ate up three-quarters of export earnings.

That debt has now dwindled almost to nothing, as foreign reserves, boosted by a windfall of cash from oil and gas sales, have mounted beyond $120 billion. Overall unemployment has shrunk to a manageable 12%. With the value of energy exports quadrupling since 2002 and expected to top $80 billion this year, the government has embarked on a giant spending programme that aims, among other things, to double power-generation capacity and to boost oil output by 50% within five years.

Come back, all is forgiven

Investors, long spooked by Algeria's toxic mix of lawlessness and business-repellent socialist laws, have returned in force. It is easy to see why. Egyptian and Qatari firms, for instance, have snapped up two-thirds of a mobile-telephone market whose subscriber base has shot up from 1.4m to 28m in just four years. The French chamber of commerce in Algiers says the number of French companies working there has tripled since 2004, with French direct investment, excluding the oil sector, reaching $233m in 2007.

Still, Algeria's troubles are hardly over. This week a French construction company, Razal, evacuated its foreign staff after a bomb killed two employees. The frequency of such attacks had dropped dramatically since the late 1990s, reflecting a fall in recruitment to Islamist guerrilla groups as well as the success of government policies that have matched broad amnesties for former militants with the beefing up of security forces.

But three devastating suicide bombings in the past year, along with the persistence of smaller-scale incidents that have taken an average of 20 lives a month since January, continue to feed anxieties. Few analysts expect a return to anything like the full-scale mayhem of the 1990s, largely because armed Islamist radicalism has lost much of its appeal. Many also discount the importance of a move, two years ago, by the main surviving guerrilla group to align itself formally with Osama bin Laden and rebrand itself as “al-Qaeda in the Islamic Maghreb”. The group's switch from direct attacks on the security forces to suicide bombings and small-scale ambushes may be a sign of relative weakness.

Yet while most Algerians are enjoying greater calm and better prospects, the underlying structural problems remain severe. Despite a veneer of political pluralism, popular disenchantment with a dirigiste state beholden to rival cliques of army officers and powerful bureaucrats is deep. Turnout for parliamentary elections, which were touted as democratic but have produced little change, fell from 45% in 2002 to 35% in 2007.

Among people under 30, who make up 70% of the population, anger at what they call *la hogra*, a sense of victimisation due to the government's neglect and contempt, could turn explosive. A jobless rate for youths of 25% and a housing shortfall estimated by the government itself at some 1.5m homes are only part of the trouble. Serious riots that erupted in the past month were sparked in one case by ethnic tensions between Arabs and Berbers and in another because a football team was demoted to the second league. Many Algerians remember uncomfortably that the drift into civil war began, 20 years ago, when similar local riots started to spread across the country.

Israel

Discord as the band plays on

Jun 12th 2008 | TEL AVIV
From The Economist print edition

Short budgets—and tempers—at Israel's premier orchestra

AFP

Allegro furioso

THE Israel Philharmonic Orchestra is one of the country's most glittering cultural jewels. Created ten years before the state, it has gone out to the battlefields in wartime to boost the troops' morale, and built a reputation as one of the world's leading orchestras. But in a country stuffed to the rafters with classical musicians, many of them immigrants from the former Soviet Union, competition for funds is inevitable—and increasingly bitter.

But that, the management at the Philharmonic seems to feel, has gone far enough. So it has mounted a public campaign to shame the government into giving it more money, after being allotted a little over 8m shekels ($2.37m) this year, some 1.5m less than it got last year.

Avi Shoshani, the orchestra's director, blames the cuts on the fact that the number of cultural bodies in Israel is growing but the state budget for the lot of them is not. The government now covers around 12% of the Philharmonic's costs. Around half—an unusually high proportion—is paid for by ticket sales and membership fees; private donors make up the difference. But this seems to irk audiences. At a gala concert last month, Mr Shoshani was jeered when he made a speech effusively thanking a corporate sponsor. It was unclear whether the anger was directed at the sponsor, the government or Mr Shoshani.

There is discontent in the ranks too. Some musicians complain that the music director, the jet-setting Indian-born Zubin Mehta, who fought to find space on an aircraft to Israel during the 1967 war and made the trip sitting on ammunition boxes, is good at bringing in the money but that there is too little time for rehearsal with him or with local guest conductors. So quality, they say, has dropped.

But the budget issue is clearly a sore point at the ministry for science, technology, culture and sport. “What budget issue?” explodes a spokeswoman, Liat Gur. The ministry has just 35m shekels to dole out to 17 different musical ensembles. Moreover, she says pointedly, one reason the Philharmonic's budget was cut was that for two years running the Philharmonic paid more than was agreed—to Mr Shoshani himself.

Turkey

Beyond the veil

Jun 12th 2008 | ANKARA
From The Economist print edition

AP

The secular and the pious march towards a new collision, with unforeseeable consequences for democracy and Turkey's chances in Europe

WHEN Adnan Menderes, a right-wing politician who spoke up for pious Anatolians, swept to power as prime minister after Turkey's first free parliamentary election 58 years ago, a group of officers began plotting a military coup within weeks. Ten years later, with the support of the secular intelligentsia and politicians, they overthrew the government, by then in its third term. A year later, in September 1961, Menderes was hanged.

Yildiray Ogur, a young activist, sees worrying parallels between the 1960 coup and today's campaign, spearheaded by Turkey's generals and judges, to overthrow Recep Tayyip Erdogan, the prime minister, and his Justice and Development Party (AKP). Turkey has been in upheaval ever since the constitutional court began considering a case brought by the chief prosecutor to ban the AKP and to bar 71 named individuals, including Mr Erdogan and President Abdullah Gul, from politics, on thinly documented charges that they are seeking to impose *sharia* law.

The stakes were raised on June 5th, when the court overturned a law passed by a big majority in parliament to let young women wear the Islamic-style headscarf at universities. By voting 9-2 to quash the law the court sent a clear signal that it would vote to shut down the AKP. A verdict is expected by the autumn.

To many the case is like a judicial coup: a last-ditch attempt to cling to power by an elite that refuses to share wealth and social space with a rising class of pious Turks, symbolised by the AKP. It may also further discredit the constitutional court. Above all, says Mr Ogur, the case reveals “an army that believes it should have the final say, not elected politicians.”

A defiant Mr Erdogan vows to fight back. In a fiery speech in parliament this week, he declared that the court had exceeded its jurisdiction and would “need to explain itself to the people.” There is talk of changing the rules for appointing judges and limiting their ability to ban political parties. Some AKP officials dream of unleashing millions of supporters on to the streets. But they know that doing so would risk provoking a real military coup. “We are like lambs being taken to slaughter, we are resigned to our fate,” sighs one AKP deputy.

A few hardy souls pin their hopes on Western support. The European Union has hinted that it would suspend membership talks if the AKP were banned. But thanks to the growing opposition to Turkish

accession in countries such as France and Austria, few Turks believe they will ever get in anyway. “With no carrots left to offer, the EU has no stick to wield,” opines Cengiz Aktar, who follows EU affairs.

The biggest deterrent to overthrowing the AKP may be Turkey's wobbly economy. After six years of steady growth the economy is slowing down, inflation has crept back to double digits and this year's current-account deficit is expected to rise to 7% of GDP. Faik Oztrak, a former treasury under-secretary and opposition parliamentarian, reckons that Turkey will need at least $135 billion in foreign inflows to plug the gap. As he asks pointedly, “where will it come from?”

Investor confidence has been rattled by the government's indecision over extending an IMF deal that expired in May. “With financial markets remaining jittery, Turkey is walking on a tightrope, making policy errors potentially costly. In particular, new initiatives that jeopardise the achievement of the announced fiscal targets, such as the planned reform of municipal finances, could tilt the balance of policies and should be avoided,” Lorenzo Giorgianni, the IMF's mission chief for Turkey, says. He is referring to the government's plans to boost local spending.

Yet in Istanbul many financiers seem unfazed. They see no reason for alarm, even if the AKP is banned. A chastened, wiser AKP would simply regroup under a different name and it will be business as usual, the argument goes. Certainly, when a party is banned (they tend to be either pro-Kurdish or pro-Islamic) its members usually come together under a new banner. But Islamic parties often come back even stronger. The AKP itself is an offshoot of Virtue, a party that was banned in 2001. It romped to power in 2002 and won a second term last year with a bigger share of the vote.

Even if it were disbanded, the AKP's surviving parliamentarians would remain as independents in sufficient numbers to be able to force another snap election. Indeed, the million-dollar question, as one European diplomat puts it, is “whether those who are perpetrating this strategy against the AKP will let them come back even stronger. They are stuck between a coup and a hard place.”

Not everyone thinks that the AKP will emerge unscathed. Even his allies agree that Mr Erdogan made a strategic blunder by passing the headscarf law instead of blending it into a package of broader reforms embodied in a new constitution. Instead of appeasing secular fears, some AKP members crowed that the headscarf would soon be allowed in government offices as well. Many say the void left by Mr Gul, who moved up from foreign minister to become president last August, is partly to blame for Mr Erdogan's mistakes. As number two in the AKP, Mr Gul had often curbed Mr Erdogan's rasher instincts.

Meanwhile, support in the Kurdish south-east, where the AKP made big gains last year, has been waning ever since Mr Erdogan yielded to army pressure and authorised cross-border attacks on PKK terrorists in northern Iraq. He also snubbed members of the pro-Kurdish Democratic People's Party (DTP) in parliament. Police brutality and mass arrests during a May 1st demonstration in Istanbul have not helped his image.

Yet, for all his and the party's failings, recent opinion polls suggest that the AKP retains a big lead over its rivals. “You may criticise us for going slow on reforms, but the truth is that we made more changes than Turkey was able to absorb,” says Abdurrahman Kurt, an AKP member from Diyarbakir. By giving pious Turks a political voice, the AKP has also bolstered their faith in democracy.

By overturning the headscarf law, says Mazhar Bagli, a sociologist at Diyarbakir's Dicle university, the court is running the risk that “radical groups will now seek their rights through illegal means.” In other words, the threat of radical Islam in Turkey may have increased thanks to the secularists' attack on the AKP.

Economist.com WORLD EUROPE

The Ruhr

A region revived

Jun 12th 2008 | DUISBURG AND ESSEN
From The Economist print edition

Germany's old industrial heartland finds some new, cleaner activities

LIKE Caesar's Gaul, North Rhine-Westphalia is divided into three parts: the rich Rhineland, middling Westphalia and the poor, sooty Ruhr. Except that the Ruhr is no longer quite so poor. Nearly a million jobs have gone since the heyday of coal and steel in the 1950s, but the Ruhr is clawing them back in cleaner businesses. Its growth has outpaced the other two parts of the state from 2001 to 2005. It leads in the creation of jobs paying social-security contributions, says Hanns-Ludwig Brauser of metropoleruhr, a development agency.

Last year's decision to phase out coal subsidies by 2018 meant “breaking free” from a mentality shaped by heavy industry and handouts, says one local economist. Duisburg's last coal pit is to close shortly. But the town, which claims to be the world's biggest inland port, is using its position on the Rhine and Ruhr rivers to trans-ship goods between middle Europe and Antwerp and Rotterdam. Thanks to booming world trade, Duisburg's unemployment has fallen from 17% to 13%.

Clusters are sprouting elsewhere. A thicket of universities and hospitals sustains biotechnology and health care. One of Germany's big four energy companies is based in Essen; another is in Dusseldorf. Nokia made headlines this year by shutting its mobile-phone factory in Bochum, at the cost of 2,300 jobs. There was less noise when research and development on BlackBerry devices started, creating 500 jobs. Steel jobs have gone, but production and profits are booming; Europe's newest blast furnace has just opened in Duisburg.

The region's transformation is incomplete. It has gone further in the south than in the more depressed north. But even in booming Duisburg old habits are fading more slowly than the industries that fostered them. Less than 30% of school children take pre-university diplomas, compared with 36-37% in the state as a whole, complains the town's mayor, Adolf Sauerland.

Progress would be swifter if collaboration were closer. But the Ruhr is split into 53 municipalities, many of them reluctant to cede power or share resources. It may no longer be true that trams cannot cross from one place to another because the tracks have different gauges, but it is still the case that each district insists on running its own expensive transport system. Local patriots are hoping that Ruhr.2010, a year-long cultural festival, will forge a stronger regional identity. And the effect on visitors? The Ruhr may henceforth conjure up thoughts of greasepaint, not grease.

Economist.com WORLD EUROPE

Germany's Christian Democrats

The Rüttgers effect

Jun 12th 2008 | DUSSELDORF
From The Economist print edition

How North Rhine-Westphalia's premier tugs his party leftwards

A FEW people loom larger over Germany than their jobs seem to justify. Oskar Lafontaine, co-chairman of the Left Party, frightens rivals into bowing towards his populism. Andrea Nahles, a vice-chairwoman of the Social Democratic Party (SPD), voices its leftist mood more than most of her party's bigwigs. And Jürgen Rüttgers, the Christian Democratic (CDU) premier of North Rhine-Westphalia, helps to nudge the whole country to the left.

His job is hardly small: North Rhine-Westphalia is Germany's most populous state. But Mr Rüttgers makes a splash far beyond its borders. His election in 2005, which ended 39 years of SPD rule, prompted Chancellor Gerhard Schröder to call an early federal election, which he lost. Styling himself the "workers' leader", Mr Rüttgers denounces raw-edged capitalism and preaches policies to temper it. He has written a book called "The Market Economy Must Remain Social".

His ideas make headway despite the misgivings of the CDU's liberals. In 2007 Germany's grand coalition of the CDU and SPD lengthened the period of paying unemployment benefits to older workers, a partial rollback of Mr Schröder's reforms suggested by Mr Rüttgers. He now wants a higher minimum pension for people who have contributed for 35 years. Angela Merkel, the CDU chancellor, was sceptical but has offered a compromise.

His partner in North Rhine-Westphalia's government, the liberal Free Democrats (FDP), is the party most likely to disagree. Unlike Ms Merkel, Mr Rüttgers does not govern with a competitor who badmouths reform. His coalition agreement with the FDP calls for "freedom before equality" and "private before state", unfashionable notions in a country that profits from globalisation but is also bewildered by it. The CDU yearns to free itself from the SPD in next year's federal election and rule in tandem with the FDP. North Rhine-Westphalia's coalition is a "blueprint", says Mr Rüttgers. Would that mean policies of the left enacted by parties of the right? Or would social sloganeering provide camouflage for more reform?

The second, perhaps. Mr Rüttgers's predecessor, Peer Steinbrück, now finance minister in Berlin, says that "Rüttgers talks left but governs right." Others agree. Despite the social rhetoric, he has set "a clear competitive course" for North Rhine-Westphalia, says Christoph Schmidt of RWI Essen, an economics institute.

Mr Rüttgers, who inherited a debt of €110 billion ($145 billion), slashed the deficit by more than two-thirds. He helped broker a plan to phase out a €2.5 billion annual subsidy to coal-mining in the Ruhr. He freed universities to manage their own affairs, including charging tuition, and offered more flexible hours at kindergartens but asked parents to cover a bigger share of the costs. He wants to privatise low-income public housing.

After lagging for years, North Rhine-Westphalia's growth is now beating the national average. This is partly luck: exports are skewed towards fast-growing emerging markets. But Mr Rüttgers deserves some credit. Spending cuts created room to build new roads instead of merely maintaining old ones, says Udo Siepmann, executive director of Dusseldorf's Chamber of Industry and Trade. Mr Rüttgers reinforced the school system by hiring some 5,000 extra teachers. "The business climate has improved since the change of government," says Mr Siepmann.

Yet Mr Rüttgers faces charges of heartlessness. Parents are withdrawing their children from kindergartens, complains Hannelore Kraft, the SPD candidate to challenge him in 2010. A €13m programme to subsidise lunch for poor schoolchildren is too small. Mr Rüttgers has presided over a "marketising" of universities. He reserves his social impulses for areas of policy where Berlin has the final say, his critics grumble.

It might all be a pose. Mr Rüttgers rules a state shaped by heavy-industry traditions and trade unions. He has a reputation as a cultural conservative (he once proclaimed the superiority of Catholicism). Some say he aspires to be a father figure in the mould of Johannes Rau, the SPD state premier in the 1980s and 1990s who later became Germany's president. But he seems self-contained, not paternal.

Mr Rüttgers insists that reform is only possible “if people don't feel it means less for them.” He sees no tension between social goals and economic efficiency. Companies that rationalise too much reduce productivity. Better education translates into higher GDP. What looks like contradiction is “the politics of balance”. From Monday to Saturday, North Rhine-Westphalia's rules on shop-opening hours are the “most liberal in Germany”. Sunday, he says, is for the family.

If the state election were held now, Mr Rüttgers and his coalition would probably win again. He thinks the same team can triumph at federal level. The CDU has a popular chancellor in Ms Merkel. As a campaign theme he suggests “security in a time of change”. The SPD will no doubt propose something equally banal. But reconciling security and change is the hard part.

Italy's centre-left

Appeasement

Jun 12th 2008 | ROME
From The Economist print edition

Walter Veltroni risks being too nice to Silvio Berlusconi

IN HIS first speech to Italy's new parliament, Silvio Berlusconi declared that he and his colleagues were “breathing in deep this new air”. The prime minister was not talking of his big majority, but of the constructive engagement of the opposition leader, Walter Veltroni.

The legislature that emerged from the election in April has a tidier, British look. On the right is Mr Berlusconi's People of Freedom alliance, linked to the Northern League and a smaller Sicilian party. On the left is Mr Veltroni's Democratic Party (PD), yoked to a small anti-corruption party. In place of Britain's Liberal Democrats stands the Catholic Union of Christian and Centre Democrats. Mr Veltroni even has a Westminster-style “shadow cabinet”.

Yet Mr Veltroni's idea of opposition does not appear British at all. He has passed up a string of opportunities to embarrass the government, thereby helping to boost Mr Berlusconi's popularity, which has risen since the election. One chance came when a journalist, Marco Travaglio, reminded television viewers that Mr Berlusconi's choice for Senate speaker, Renato Schifani, was once a business partner of people later convicted of Mafia involvement. Far from demanding more details, the PD's Senate leader, Anna Finocchiaro, called the remark “unacceptable”.

Then there is Alitalia. Mr Berlusconi promised to find an all-Italian consortium to save the airline. More than two months later—and €300m ($465m) poorer after a state loan to Alitalia—the country is still waiting. Yet this has scarcely been mentioned by the PD. The party has been just as restrained in attacking the government's harsh measures to deal with immigration and security, which have raised eyebrows in Brussels (and in the Vatican). Nor has it fussed about Mr Berlusconi's plan to ban most police phone-taps.

What is going on? Mr Veltroni says he is keen on “dialogue”. The advantages for Mr Berlusconi are clear: he can slough off his partisan image and re-emerge as a consensus man, perhaps a candidate for the presidency. But the benefits for the left are less evident. Even before the election, Mr Veltroni said he wanted to co-operate with Mr Berlusconi on electoral and constitutional reforms to make Italy easier to govern. A noble aim, except that it has been tried before, with disastrous consequences.

In the 1990s, at the insistence of Massimo D'Alema, leader of the biggest left-wing party, the centre-left government held off passing laws to break Mr Berlusconi's virtual monopoly on private television. Mr D'Alema hoped to win Mr Berlusconi's support for political reform. But Mr Berlusconi then torpedoed the project—and returned to power in 2001 with his media empire intact.

Yet appeasement has a strong appeal to Mr Veltroni, who is in a vulnerable position. One reason why the centre-left government of Romano Prodi began to flounder was that the PD's leader sought to distance himself from it after being chosen last autumn. His election strategy largely failed: he rejected an alliance with parties to the left, insisting that the PD must run alone. And his choice of candidate for mayor of Rome proved woefully wrong. Francesco Rutelli, who had already run the city twice, managed to reduce the centre-left's vote from 62% to 46%.

Dialogue, with its promised role in building a new Italy, precludes the tortured post-mortem that a defeated party might otherwise hold. Yet that may be what the left needs. Rooted in a discredited creed, Eurocommunism, and a discredited movement, Christian democracy, its main leaders—Mr Veltroni, Mr Rutelli and Mr D'Alema—have been rejected by voters, outwitted by Mr Berlusconi or both. The risk is that Italy may get not a shadow government, but a phantom opposition.

Russian reform

White nights

Jun 12th 2008 | ST PETERSBURG
From The Economist print edition

Some hopeful signs from the St Petersburg economic forum

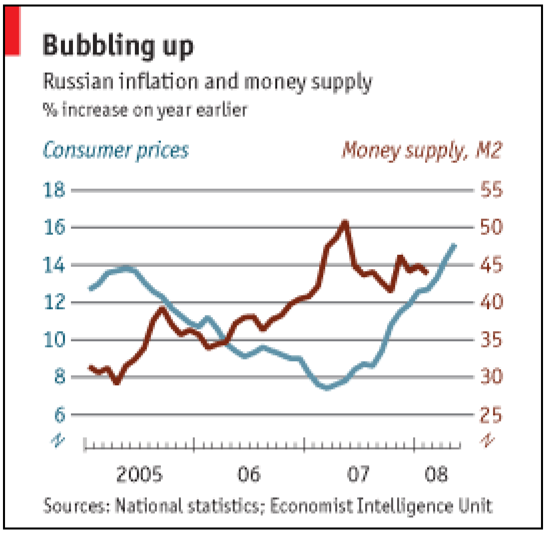
THERE was nothing odd about Russia's big economic forum in St Petersburg this year. An inflatable pig floated in the sky as Pink Floyd's former lead singer deafened the winter palace. A rocket-proof yacht belonging to Roman Abramovich, a London-based oligarch, dazzled tourists. Security guards harassed those they did not like the look of. Few are surprised by the oily excesses of Russian capitalism.

What was surprising was the air of change vented by some officials. Igor Shuvalov, Vladimir Putin's deputy prime minister, set the tone with a speech immediately branded as “the new course”. Mr Shuvalov, who co-ordinates Russia's dual power structure with President Dmitry Medvedev, said that to become a free and innovative country Russia needed to develop democratic institutions, modernise education and improve the health of its citizens. He added that the state must meddle less in the economy and, crucially, that “we must repeat again and again: protection of property rights is the first and most important task of the state.”

This is hardly revolutionary stuff, but compared with many speeches from the Kremlin, it seemed a revelation. Mr Shuvalov was surrounded by progressive businessmen and politicians as well as foreigners. His comments reflect a consensus among Russian businessmen, says Sergei Guriev, head of Russia's New Economic School, which has surveyed some 60 chief executives. Most want Russia by 2020 to be “free, educated and law-abiding”; only 22% want it to be “strong”. Just 6% fear foreign aggression; most feel that Russia's problems are internal, including the demographic outlook, corruption and the Kremlin's disregard for the law.

That Russia's top businessmen have similar views about the future is not surprising. But their public airing in St Petersburg was seen by some liberals as a breakthrough. Cynics suggested that people who had enriched themselves over the past eight years need to legitimise and protect their property. But it is also clear that today's centralised and corruption-addled system cannot deliver diversification of the economy and sustainable growth.

One sign of this is inflation, which has almost doubled in the past year and is now 15% (see chart). The World Bank and the IMF both say the economy is overheating, domestic demand is outpacing growth, industry is running near full capacity and real wages are growing faster than productivity. Imported food inflation is part of the problem, but so is rapid money-supply growth and the cash pouring into state corporations. Elections often bring higher public spending, but in Russia it was the bureaucrats, not pensioners, who gained.



The best way to fight inflation, says Arkady Dvorkovich, an economic adviser to Mr Medvedev, is to increase competition and raise investment. He argues that Mr Medvedev's first decrees—protecting small companies from bureaucracy, setting up federal universities—signal a new direction. But the question is how far Russia's new political class is prepared to go. It was left to Anatoly Chubais, architect of the 1990s' reforms, to say that improving the efficiency of the state would be impossible without true democratic elections.

The signs are that Mr Shuvalov and company are trying to fix problems by upgrading the system rather than reforming it. He went out of his way to say that his speech merely fleshed out the strategy of Mr Putin and Mr Medvedev. Mr Medvedev's own speech was little more than a repeat of one made by Mr Putin last year, with a trademark rant about American egoism and Russia's aspiration to become the

financial centre of the world.

It is unclear how hopes of fostering more innovative and creative young people and sending them to study abroad can co-exist with a corrupt conscription army that cripples intelligent young men physically and mentally; or how Mr Shuvalov's call to be open to foreign specialists tallies with rigid visa rules. Actions can speak louder than words. Recently specialists working for BP, a global energy firm, have run into visa problems. The migration service says the quota for foreign work permits in Moscow is now full.

And though Mr Shuvalov talks of a more modest state role in the economy, a fierce fight is raging about the assets of a state holding company set up by Sergei Chemezov, a former KGB colleague and close friend of Mr Putin. Rostekhnologii, created to promote Russian technology, wants to take control of hundreds of firms in which the state has a stake. Alexei Kudrin, the finance minister, opposes the untransparent transfer and sale of civic assets. He says this would amount to “a covert privatisation and the loss of control over how the proceeds are spent.”

“Russia's problems cannot be fixed by only some special measures, we need fundamental changes,” says Andrei Sharonov, a former official. But the new rhetoric is mildly encouraging, as was a decision to drop charges against Manana Aslamazian, head of a media foundation who faced criminal prosecution for a trivial offence. Mr Shuvalov and Mr Medvedev have not done enough to qualify as liberals, but they are a new team eager to make a mark.

Yet Mikhail Gorbachev's *perestroika* also began as an attempt to spruce up the economy and give the Communist Party new life. It soon sped out of its author's control. The difference, says Kirill Rogov, a political analyst, is that Mr Gorbachev's reforms were helped by falling oil prices. Mr Medvedev has had no such “luck”.

Charlemagne

Fishy tales

Jun 12th 2008
From The Economist print edition

Europe's governments must ignore fishermen's demands—for the sake of the fishing industry

Illustration by Peter Schrank

RATIONAL debating points are hard to hear above the din of breaking glass, water cannon and a car being overturned. Luckily, the fishermen who recently demonstrated outside the European Commission to complain about fuel prices stuck to a simple list of grievances (before their protest disintegrated into the usual baton charges and splintered office windows).

Fishermen are striking, marching on capitals and blockading ports all over Europe. Broadly, they want three things. The first is subsidies to cut the price of marine diesel by 40% or more. Second, they want the European Union's quotas eased to let them catch more fish. And third, they complain that they cannot pass on their rising costs. They blame this on cheap imports (which they want controlled) and on the system of selling catches in quayside auctions, which they say gives buyers too much power (they want this investigated).

With one partial exception, these are all terrible ideas. One fishing representative in Brussels declared that only cheaper fuel could give Europe a “sustainable fishery”. The exact opposite is true. Marine diesel is already subsidised in effect, because it is tax-free. More subsidies would reduce the already slim chance that Europe will ever have a sustainable fishing industry. Raising quotas would be worse still. The commission says that 88% of EU stocks are “overfished”, compared with a global average of 25%. As for controlling imports, the idea is nonsense. Most of the fish eaten in the EU is imported, and will remain so, as demand long ago outstripped domestic supplies.

European governments would be irresponsible to give in to these demands. Alas, when it comes to their fishermen, they have shown abject cowardice for years. The industry has political clout way beyond its size (you could seat every fishing-boat skipper in Europe in a single football stadium). This is for various reasons: fishing is concentrated in coastal regions with few other obvious jobs; some fishermen are prepared to riot for political ends; they all do a romantic, dangerous-looking job. A government that is tough on fishermen seems mean to millions of voters who have never handled a net in their lives.

Here are some things that EU fisheries ministers lack the courage to say in public. There are fewer boats now, but that does not mean fishermen are heading for extinction. Today's boats are more capable, with better engines, hull designs, nets and electronic gadgets that lead them straight to the fish. A rule of thumb says there is 2% “technology creep” a year. Even if fish stocks were stable (which they are not), Europe would need to scrap many boats every year to maintain a sustainable industry.

Instead, it has done the opposite, propping up fleets that are anywhere from 20% to 60% too large. And too many governments have then tried to square this circle by lobbying for higher quotas. This has locked fishermen in a suicidal spiral. Decades of falling catches have induced them to travel farther to fill their holds: one reason why Spanish skippers hate expensive fuel is that so many sail way beyond EU waters.

More fuel is being used by fleets all round the world, and falling fish stocks are “the major driver”, says Peter Tyedmers, an economist at Dalhousie University in Canada. Nova Scotian fishing records stretching back to the 1930s show that today's boats burn over four times more fuel to catch a tonne of fish, despite having far more efficient engines. Most of the fisheries that he has studied are burning more fuel than 50 years ago.

Availability matters. Herring fishermen in Canada may use only 30 litres of fuel to catch a tonne of fish, because they can throw their nets nearer to home (a practice so cheap that herring is used as lobster bait). European herring fishermen burn 100 litres a tonne, even when using the same (highly fuel-efficient) technique of throwing a purse seine net round a school of fish. Fishing methods matter, too. It takes lots of fuel to pull a heavy net behind a trawler, or tow long lines with hooks for prey like tuna: figures of 3,000 litres of fuel per tonne of fish are common.

Many European fleets are shaped by business choices made when diesel was cheap. The biggest supertrawlers can be crewed by only 20 men: essentially they have substituted fuel for labour. The Netherlands has some of the world's most efficient trawlers for flatfish, in terms of tonnes caught per vessel in a day—but they drink fuel at a fearsome rate. Yet unlike the French or Spanish fishermen who demand fuel subsidies, Dutch fishermen know such aid is not on the table, says Albert Vermue, director of fisheries for the Dutch government. “Subsidising fuel does not tackle the root of the problem,” he says. Instead, fishermen must find different ways to catch fish.

Collusion at the quayside

And the single exception in the fishermen's list of terrible ideas? It may be worth investigating why some EU fish prices have fallen this year, despite rising costs. Partly it is because wild fish are so easily substituted, robbing fishermen of market power. When Europe's fish becomes more expensive, consumers can swap to farmed pangasius (catfish) or tilapia from Asia, or just buy chicken. But there is also a whiff of collusion among big middlemen in some European auctions.

Fishermen should be able to charge a premium for their fish, but too many lose interest once the catch is landed, says one official. A bit more collaboration among fishermen on joint marketing and labelling could help. But fishermen are by nature hunters and individualists, he says; it is hard to persuade even brothers in a single fishing family to co-operate.

Europe's fishermen (and their descendants) may yet have a viable industry. But to create one will involve ignoring their demands for help. The signs are that high fuel costs are structural, so that temporary aid will only put off the pain of making changes. That will remain true no matter how many cars are overturned or windows smashed in Brussels.

The Bank of England

Credibility at stake

Jun 12th 2008
From The Economist print edition

In its battle against inflation (and interfering politicians), Britain's central bank faces its most difficult test

Getty Images

OF ALL Labour's measures since 1997, its shake-up of the Bank of England within days of winning power was the most talismanic. Making the central bank independent to set interest rates said more loudly than any rhetoric that the party had changed its ways. And the reform appeared to be a masterstroke. For virtually all the ensuing decade, the economy thrived, inflation stayed low and banks were accident-free. But as Britain's financial system and economy have stumbled, Labour has become less enamoured of its creation; and the public has lost faith in both the politicians and the central bank.

Relations between the government and the Bank of England soured in the first place because the reform of 1997 failed its first serious financial test. Although the central bank gained the power to determine interest rates, it lost its supervisory powers over banks to the new Financial Services Authority (FSA). This divided arrangement, in which the central bank was still supposed to ensure financial stability, worked woefully when Northern Rock ran aground last year. The FSA proved a careless and supine supervisor and the Bank of England tardy and flat-footed when financial markets seized up.

Keen to prevent another such fiasco, Alistair Darling, chancellor of the exchequer since June 2007, wants to strengthen the central bank's ability to maintain financial stability. But because he is unwilling to unpick the reform of 1997—by restoring some supervisory role to the central bank—the chancellor has resorted to initiatives that smack of an unwelcome return to political interference. There has been an unhelpful tussle over who should replace Rachel Lomax, the deputy governor in charge of monetary policy who is leaving shortly.

Mervyn King, the bank's governor, now looks set to get his way in this dispute—the job is expected to go to his preferred candidate, the bank's chief economist, Charles Bean—but he faces another check to his authority. Mr Darling said on June 5th that he wants to bring in “outside expertise to advise the governor” on financial stability. Arguably, this addresses a weakness in the central bank, which has lost touch with the day-to-day business of banking since losing its supervisory role. But the idea also looks like another sign of Labour's waning enthusiasm for the central bank's independence.

The friction between the government and the Bank of England is particularly worrying as the economy deteriorates. The central bank may, together with the FSA, have let down the side in its handling of the financial crisis. Mr King promised bankers this week “to put in place a liquidity facility that works in all

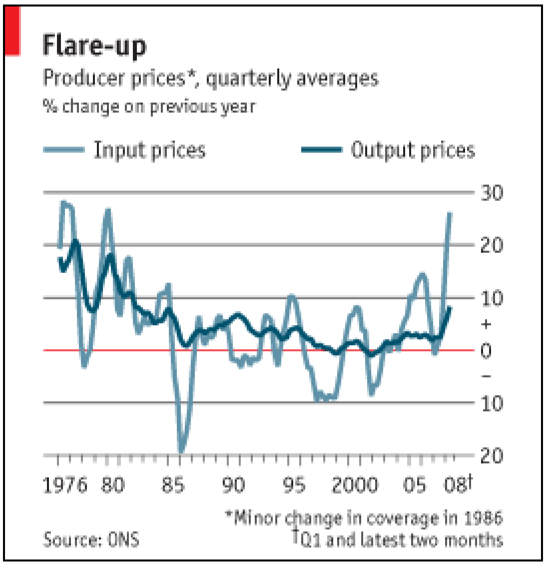
seasons". But the economic test it is now facing matters even more for its reputation: a grisly mixture of higher inflation and slowing growth, with a rising risk of recession.

During most of its first decade of independence, the Bank of England presided over a remarkably benign period of low and stable inflation. The 1997 reform requires the governor to write to the chancellor if inflation diverges from the target by more than a percentage point. Prices held so steady that no letter proved necessary until last year.

When Mr King first put pen to paper, in April 2007, consumer-price inflation had climbed to 3.1%, well above an inflation target set at 2.0%. Although this was an unwelcome blow, the governor could depict the rise in inflation as a temporary aberration. Mr King pointed to the bank's own forecast, which showed a subsequent fall.

That decline duly occurred, but over the past few months a more menacing upsurge in inflation has got under way. Consumer prices are already rising by 3.0% and another letter seems likely as soon as June 17th, when newer figures are to be published. This time Mr King will not be able to point to a comforting forecast. The bank's projections in May envisaged inflation rising to 3.7% by the end of the year and still hovering above 3.0% next spring.

Since the central bank made those forecasts, the inflationary outlook has turned nastier still. Cost pressures right through the supply chain to retailers are now intense (see chart). The prices charged by manufacturers for domestic sales rose by 8.9% in the year to May, the highest since March 1982. A further jump seems likely next month, since the prices manufacturers themselves pay for their fuel and materials soared by 27.9%, the highest since November 1976.



Adding to the cost pressures on retailers, the fall in the pound—whose average value in May against a trade-weighted basket of currencies was 12% lower than last July—is pushing up import prices. The cost of importing goods (excluding oil) rose by 6.7% in the three months to April compared with the same period a year ago, the fastest rate since late 1995.

But the gravest worry for the Bank of England is that an inflationary mentality has returned. For most of the time since the bank started quarterly surveys of attitudes to inflation in 1999, the public has thought that prices would increase by 2-2.5% in the 12 months ahead. More recently that median expectation has been rising. After reaching 3.3% in February, expected inflation jumped to a record 4.3% in May, according to figures released on June 12th.

The increase in inflationary expectations sharpens the dilemma confronting the Bank of England. The bank thinks a slowdown arising largely from the credit crisis will be enough to quell inflation after the current surge caused by higher global energy and food prices subsides. But the more that people expect higher inflation to persist—and act on that view when they set prices and negotiate wages—the harder it will be for the bank to restore price stability without driving the economy into recession by raising interest rates. The City now expects the bank, which has lowered the base rate from 5.75% in early December to 5.0%, to start raising it later this year.

During the long period when the economy was doing so well, Gordon Brown claimed much of the credit, not least for setting the Bank of England free. Others suggested that he had got lucky. Now economic misfortune has returned, setting both Labour and the bank by far the trickiest test that either has faced.

Tory resignation

Davis blows his top

Jun 12th 2008
From The Economist print edition

The dramatic resignation of the shadow home secretary

HE HAS a lead over Gordon Brown of 20 points in some polls. He seemed to have finally buried the internecine squabbles that have hobbled the Conservative Party for more than a decade. David Cameron, the Tory leader, was beginning to assume the air of prime-ministerial inevitability that Tony Blair acquired in the mid-1990s: if he and his team sat tight, it appeared, he would land in Downing Street in 2010. So it was astonishing when, on June 12th, David Davis, the shadow home secretary and thus one of Mr Cameron's chief lieutenants, announced that he would be resigning his job and parliamentary seat.

Mr Davis, who is planning to contest the resulting by-election in his north-eastern constituency of Haltemprice and Howden, said his purpose was to give the voters a chance to register their views on “the slow strangulation of fundamental British freedoms”. His concerns go wider than the vote in the House of Commons, on June 11th, to extend to 42 days the time people suspected of terrorism can be detained without charge (see article): this was, he said, only the latest example of the government assuming intrusive powers that were creating “a database state”.

Mr Davis talked about *Magna Carta* and *habeas corpus*, and has consistently opposed the government's illiberal laws. But politics, as well as principle, may be involved. Mr Cameron called the stand “courageous”—but emphasised that Mr Davis's decision was a personal one; he announced that Dominic Grieve would be taking on the home-affairs brief. There were whispers of a split between the Davids over whether, in office, they would repeal the 42-day law (assuming it becomes one). The fact that Mr Davis had consulted the Liberal Democrats, who also opposed longer detention, will also irk some Tories. The Lib Dems immediately said they would not run a candidate against him.

When Mr Cameron won the party leadership in 2005, Mr Davis—a formidable street-fighter of a politician—was his closest rival. For a time he was regarded as Mr Cameron's main internal threat, despite his professions of loyalty. How much personal ambition and vanity were involved in this decision, only Mr Davis knows. Whatever his reasons, they have produced an extraordinary outcome: a discretionary by-election, triggered by a sitting MP, ostensibly to be fought over a single issue.

Detention without charge

Home and dry, just

Jun 12th 2008
From The Economist print edition

Gordon Brown wins a Pyrrhic victory

PA

Whew, prime minister

IN THE end, the government was better at getting MPs to vote for its counter-terrorism bill than at making the case for it in the first place. Wavering backbenchers were seduced by phone calls from Gordon Brown, the usually aloof prime minister. David Miliband, the foreign secretary, was recalled from a trip to the Middle East. Some suggest that generous boondoggles were thrown at (among others) Northern Ireland's Democratic Unionist Party, whose nine MPs in effect decided the vote.

Whatever the means, though, the end was that on June 11th the House of Commons voted by a margin of 315 to 306 to extend the maximum period a terrorist suspect may be detained without charge from 28 to 42 days. The House of Lords could yet reject the bill; if it did, the government would most likely invoke the Parliament Act to force through the legislation.

Though Mr Brown has avoided the defeat suffered by Tony Blair, his predecessor, when he tried to extend the limit to 90 days in 2005, this is far from an unalloyed triumph for him. For one thing, the concessions to hesitant MPs are so hefty that it is unclear whether the bill is a meaningful increase in police powers at all. For example, Parliament would debate and vote on any extension beyond 28 days within a week of a request from the home secretary. Yet if enough information were provided to make parliamentary scrutiny significant it could also prejudice any trial that resulted. David Cameron, the Conservative leader, calls it “ineffective authoritarianism”.

Mr Brown has also alienated liberal opinion at a time when his stock is already low among sections of the left due to unpopular income-tax changes. Not that opponents of the legislation were all unworldly ideologues. The director of public prosecutions, a former attorney-general, a former lord chancellor and Parliament's Joint Committee on Human Rights all regard the current 28-day limit as sufficient. On June 6th even John Major, the usually circumspect former Tory prime minister, registered his dismay at the proposal.

Moreover, if ministers hoped the Tories would pay an electoral price for opposing a measure that is popular in the country, they are likely to be disappointed. True, an ICM poll published on June 8th showed 65% of the public backing the government on 42 days. But it also showed the Tories narrowly leading on the issue of terrorism, suggesting that their reputation as the party of national security, as well as their support for alternatives to 42 days (such as post-charge questioning and the use of intercept evidence), shields them from taunts of weakness. It may be that, even when they agree with him, many voters have just stopped listening to Mr Brown.

Supporters of the bill, who include Lord Carlile, the independent statutory reviewer of anti-terrorism laws, and many police chiefs, insist that the bill is necessary. Terrorism investigations can be stupefyingly complex: thousands of gigabytes of encrypted data must be studied and plots tracked across different continents. The fact that so far no case has required more than 28 days is, they say, irrelevant: better to legislate this reserve power now than to wait for a crisis to justify it.

Many of those unmoved by these arguments will suspect that Mr Brown's motives were political. If so, it was a short-sighted gambit. A victory on a matter of national security will be enough to mute, temporarily, speculation about a leadership putsch against him. But a longer-term reversal of his party's grim fortunes—on June 10th Populus became the second polling firm in recent weeks to show a Tory lead

of 20 percentage points or more—will require rather more. The revelation on June 11th that a senior intelligence official working in the Cabinet Office had left secret documents about Iraq and al-Qaeda on a train was an unpromising start.

The poor

Always with us

Jun 12th 2008
From The Economist print edition

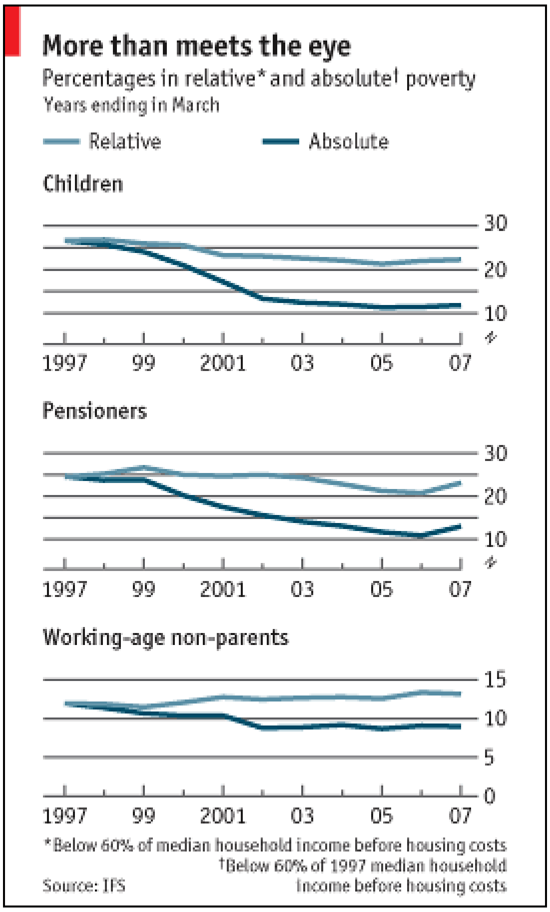
Defining poverty is hard. Eliminating it is harder

LABOUR'S goal of ending child poverty, emblem of the brave new world a new government intended to build in Britain, is less vision than nightmare these days. Always ambitious, the target now looks unattainable. The government's annual poverty figures, published on June 10th, showed a rise in 2006-07 of 100,000 in the number of children living in poverty, to 2.9m. If the task of halving child poverty by 2010 en route to ending it by 2020 is to be achieved, 300,000 children must be moved out of poverty in each of the four years to 2010-11, a near-impossible task.

Ministers tried to change the subject to their longer-term record. If the government had merely increased tax allowances and benefits in line with inflation since 1997, said the work and pensions secretary, James Purnell, there would be 1.7m more poor children in Britain today. Others pointed to problems of definition. Things have improved in absolute terms, said Stephen Timms, the welfare-reform minister. Fewer children now live in what would have been called poverty a decade ago: 1.5m, down from 3.3m in 1998. The standard measure is relative, classing all those with income below 60% of the national median as “poor”. Because median income rises most years, meeting the target is like running up a down escalator, said the minister for children, Beverley Hughes. (This, though true, does not explain the recent increase in child poverty: median household income rose from 1997 to 2003, but has hardly changed since then.)

In an analysis released on June 11th, the Institute for Fiscal Studies (IFS), a think-tank, looked also at a different measure introduced last year by the government. Families are asked about 21 ways to spend money, from swimming once a month to taking a yearly holiday. After some statistical alchemy, the IFS concludes that 2m children are “materially deprived”.

And as if the lexicon of poverty were not already bloated, the Conservatives want to add another term, “severe poverty”. This describes the condition of those living on less than 40% of median income, whose numbers have risen slightly since 1997. The government, the Tories charge, has focused on those close to the poverty line and ignored the most desperate.



According to Mike Brewer of the IFS, this putative new category has little validity. Research suggests that many who report living on less than 40% of median income have high outgoings, and, on the material-deprivation measure, look better off than those on between 40% and 60%. Some of these free-spending indigents may be fraudsters; others will be self-employed people with erratic incomes or relatively rich ones going through a lean patch.

It is not only children who are poor, of course, but it is they, and pensioners, about whom the government cares most. The number of adults of working age without children who live in poverty has changed little in a decade (see chart).

That may not worry voters much. In January the annual British Social Attitudes Report turned up a significant hardening of hearts towards poor adults of working age, in particular the unemployed. But it also found general, and increasing, disquiet about inequality and fat-cattery. So people may be more moved by another of the IFS's findings: that the incomes of the top 1% grew by more than 5% in 2006-07, while those in the middle trod water.

Tamil Tigers in Britain

Burning less bright?

Jun 12th 2008
From The Economist print edition

Lean times for the Sri Lankan separatists. But Tamils are flourishing

Get article background

TERRORISM normally makes front-page news in Britain, so it was odd that the four Asian men charged with terrorist offences last month scarcely made the papers. The charge-sheet explains why: the men bundled out of their homes at dawn are suspected of procuring equipment for the Liberation Tigers of Tamil Eelam, a rebel group that has fought a decades-long civil war against the Sri Lankan state and is now banned in Britain. The police took pains to emphasise that there was no link to al-Qaeda; after that, interest dried up.

The Tigers may be little known in Britain, but it is one of their most important constituencies. War has driven a quarter of Sri Lanka's minority Tamils abroad and Britain has the biggest share after Canada: up to 200,000 Sri Lankans (including a big second generation), most of them Tamils. Professionals have thrived in London since the 1950s, helping to hatch the Tigers' nationalist ideology. The movement's international headquarters, now presumed defunct, were in London and Paris.

The historic haven is looking less comfortable these days, however. Britain banned the Tigers in 2001, five years before the rest of Europe. Counter-terrorist officers are devoting “considerable resources” to investigating them. A dedicated crime hotline provides a way for Tamils to tip off the police. And the crackdown may be working. Last year saw the high-profile arrest in London of Colonel Karuna, a renegade Tiger leader, who is still detained in Britain. Last month Canadian police produced a 2004 memo from a senior Tiger who criticised the “insufficient activities of the branches in Canada and England”. Promises of cash from foreign supporters “ended up as fictions”, he grumbled.

Whether donors give willingly to the Tigers is disputed. Police say many contributions are extorted, or obtained through credit-card fraud. But some do, and this has placed Tamil charities under scrutiny. The Treasury lists nine outfits as fronts for the Tigers, and has frozen the assets of four Sri Lankans. In 2005 Britain's charity watchdog wound up one Tamil charity after identifying black holes in its accounting. Another is under investigation; one of its trustees has been forced to step down. Grey areas abound because much of the charity work in Sri Lanka is carried out in Tiger-held territory.

Tamil nationalists face a bigger long-term challenge, however: convincing the next generation. Most of those collared by the police are older folk born in Sri Lanka (those charged last month, for example, are between 34 and 51 years old). Islamist terrorists, by contrast, are often British-born and sometimes still in their teens. At Tamil demonstrations, such as the one on June 10th in London, most are first-generation migrants, not hot-headed students.

That the struggle is rooted in geography, not religion, is one reason. Another is that young Sri Lankans are too successful to need to march or plot. They are more likely than other Asians to be employed (though they earn slightly less than Indians) and Sri Lankan children do better at school than any ethnic group bar the Chinese. Intensive extracurricular learning and well-educated parents (especially the mothers) help to explain it, suggests Jill Rutter of IPPR, a think-tank. Branding helps too: teachers may label Somali refugees damaged basket-cases, but Tamil children, sometimes no less traumatised, are stereotyped as industrious maths geeks. Labels can be self-fulfilling. Popular actresses such as Amara Karan are further signs of the community's success.

But the prospects for peace in Sri Lanka may be better if the diaspora remains politically engaged, argues Danny Sriskandarajah, born in Sri Lanka and director of research at IPPR. Diaspora Tamils, who provided three of the four people sent by the Tigers to negotiate with the Sri Lankan government in 2002, have had a moderating effect on the movement, he reckons. They are freer to criticise the Tigers than they would be in Sri Lanka. But since the group's ban in Britain, anyone who engages with the Tigers risks prison. The movement may shrink, but harden. Britain could yet hear more from them.

Money and politics

That's rich

Jun 12th 2008
From The Economist print edition

Tory pledges of probity are undermined by sleaze stories

PA

Cameron cleans house

THE current fortunes of the Conservative Party, which is now enjoying opinion-poll leads of up to 20 percentage points, are novel for an organisation that has floundered for over a decade. One of the few clouds in the Tory sky is, however, painfully familiar. Financial sleaze, which dogged the previous Tory government under John Major in the 1990s, is threatening to make a comeback.

On June 5th Giles Chichester, the leader of the Conservatives in the European Parliament, resigned after admitting to channelling expenses through a family company, a practice that was prohibited from 2003. Two days later it was revealed that Caroline Spelman, the party's chairman, had paid a nanny a decade ago out of her parliamentary office allowance. She says that the nanny performed secretarial work but others wonder how; the matter is being referred to the parliamentary-standards commissioner.

These are not the first abuses of expenses and allowances to blight the Tories recently. In January Derek Conway, a backbencher, was found to have paid his son, who was a full-time university student at the time, more than £40,000 from his office budget over three years for research work. David Cameron, the Conservative leader, removed the party whip from him.

And the controversies do not stop with public money. Private donations to the Tories have also been arousing suspicion. It was revealed in January that George Osborne, the shadow chancellor, had been declaring donations channelled through the party's central office to the Electoral Commission but not to Parliament's register of members' interests. In May the House of Commons standards committee ruled that this was improper but admitted the rules were confusing; it allowed the shadow cabinet four weeks to declare similar donations. Some of the declarations that followed seemed to involve conflicts of interests. Andrew Lansley, for example, the shadow health spokesman, took money from the owner of a medical- equipment manufacturer, and Grant Shapps, who has the housing brief, received donations from mortgage brokers and an estate agent.

Of course financial sleaze is not exclusively, or even predominantly, a Tory problem. Labour was investigated by the police for more than a year over allegations that it handed out peerages in return for loans, and in November the party's general secretary resigned when it was revealed that money had

been accepted from a donor through undeclared intermediaries. Questions have also been asked about potential abuses of expenses and allowances by Labour MPs.

On top of such concerns there is a broader fear that Labour's dire financial straits (the party is millions of pounds in debt) could have implications for government policy. In 2004 the trade unions, Labour's most dependable financial backers, extracted a range of left-wing commitments from the government (such as new rights for temporary workers) in return for financial donations to the party. A follow-up to that agreement is due to be thrashed out in July, and Labour, with creditors at the door, is not in a position to drive a hard bargain.

But Mr Cameron has adopted a high-minded attitude towards money in politics, pressing the government to tighten the law on donations and pledging to root out chicanery in his own party. Any sleaze stories that do emerge can therefore be spun by the Labour opposition as proof of hypocrisy, even if they are actually just the inevitable results of an internal audit. The case of Mr Chichester, appointed by Mr Cameron to ensure the integrity of Tory MEPs' expenses, is an embarrassing example. A Populus poll published on June 10th showed that 61% of voters think the Tories are tainted by financial scandal—a significant jump since February—though Labour fares even worse.

Sleaze alone did not doom the last Tory government, and it is unlikely by itself to forestall a new one. But further plunges in the public's already low opinion of politicians could limit enthusiasm (and indeed electoral turnout) for Mr Cameron.

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Road charging

For whom the road tolls

Jun 12th 2008
From The Economist print edition

Congestion charging comes to Manchester

ROAD pricing is much like fusion power. Both are good ideas on paper but hard to put into practice. Both have been mere decades away for half a century or so (widespread road tolling was first mooted for Britain in 1964). Theoretically, the present government has been committed to a national charging scheme since 2004. In practice, the policy is deep in the political long grass, kicked there by a lack of public enthusiasm and a petition opposing the idea that had collected 1.8m signatures on Number 10's website by the time it closed in 2007.

But on June 9th Ruth Kelly, the transport secretary, announced her support for the creation of a road-tolling scheme in Manchester. The plans call for a two-ring system to be put in place by 2013, with the outer segment bounded by the M60 motorway and the inner ring defined by a group of main roads in the town centre (see map). If the idea is approved by the ten local councils involved, it will be the first road-charging scheme in a British city since London introduced its congestion charge in 2003.

Road tolling will cover a much bigger area in Manchester than it does in London. The Greater Manchester Passenger Transport Authority, which runs public transport in the city, estimates that around a fifth of Mancunians will pay the charge (although it also points out that 30% of residents do not have access to a car). And it will be more discerning. Unlike London's flat £8 charge from 7.00am until 6.00pm, tolls will be limited to the morning and evening rush hours, and different charges will be levied for crossing each of the two rings.

Despite official reluctance to push a national scheme, the Manchester plan suggests that the government is still committed to road pricing, if not for the country as a whole then at least for its big cities. Councillors are being offered a straightforward (and attractive) bargain, with the promise of £1.5 billion of central-government money to be spent on improvements to the city's public-transport network plus £1.2 billion to be raised against the forecast £180m revenue from the congestion charge. Other cities—including Bristol and Bath—are mulling over similar deals.

Politically, the timing is uncomfortable. Oil and petrol prices are at record highs (and a four-day strike by petrol-tanker drivers planned to start on June 13th could push up prices further). There is a mutinous mood among motorists over proposed hikes in fuel duty and taxes on polluting cars. Department for Transport figures show that journey times are already falling in Greater Manchester, a trend that may become more pronounced if petrol prices stay high.

The government is unlikely to have backed a scheme it thinks will fail, but public opinion is difficult to read. Depending on the precise question asked, national surveys show both support for and opposition to the idea of road pricing. A survey carried out in Manchester last year suggested that a majority of residents supported the plan. A more recent sounding for the *Manchester Evening News*, however, showed that most respondents disliked charging and were prepared to put up with it only in return for government cash. Roger Jones, the city councillor who did most to push the scheme through, lost his seat in May's local elections. Mrs Kelly herself, who represents Manchester's Bolton West constituency with a modest majority of around 2,000, could face a similar fate at the next general election.

Opponents of the scheme—and the Conservatives—want a referendum before the cordons go up. Supporters dismiss the idea. They might profitably take note, however, of Stockholm, which introduced a congestion charge in 2007. When the idea was first mooted, it was deeply unpopular. Then Annika Billstrom, Stockholm's mayor at the time, persuaded residents to endure a trial period before making up their minds. Ms Billstrom was subsequently voted out of office, but seven months of freer-flowing roads had transformed implacable opposition into a vote—admittedly a narrow one—in favour of the charge.

Bagehot

Be afraid

Jun 12th 2008
From The Economist print edition

Gordon Brown was wrong about 42 days. But he is right about the terrorist threat to Britain

Illustration by Steve O'Brien

Correction to this article

NO DIRTY bombs. No chemical explosions. No “spectaculars”. Nobody—besides one would-be bomber—has been killed by an Islamist plot in Britain since July 7th 2005. Then some Londoners whispered, in macabre, perhaps indecent relief, that they expected the strike they knew was coming to be bloodier. Optimists might be tempted to think that Britain is over the worst; cynics that, in his quixotic drive to extend to 42 days the time suspected terrorists can be held before they are charged, Gordon Brown has exaggerated the threat for political ends. The plan scraped through the House of Commons on June 11th.

The phlegmatic and the Panglossian have some reasons to feel safe, beyond the quietness of the past three years. There are the multiple counter-terrorism laws passed since 2001, the powers conferred on the police and the new criminal offences usefully created. There is the expansion of MI5, the domestic security service, whose staff has doubled in seven years, and its tentacular spread into Britain's regions. MI5, MI6 (the overseas service), the police and foreign spooks are co-operating more closely than ever. Obvious targets have been made more robust.

The changes have paid off. Big-time strikes, such as the multiple bombings planned by the subjects of the “Crevice” investigation, have been averted. The alleged architects of an alleged plan to blow up aircraft over the Atlantic in 2006 are now in court. The effort to bomb Glasgow airport and central London in 2007 was not disrupted, but it was, in the end, more clownish than catastrophic. Most of those in other countries who once talked disparagingly about “Londonistan”—implying a calculated laxity from British authorities towards extremists—no longer do.

Optimists can likewise point to the government's maturing efforts to counteract radicalisation. After a wobbly start, a broader range of Muslim interlocutors have been enlisted. Some of the most rabid preachers have (finally) been locked up or thrown out. The cause of moderation has been bolstered by the public recantations of some former Islamists, such as Ed Husain of the Quilliam Foundation; well-publicised trials have discouraged some Muslims from denying the terrorist peril.

All that is real and important. It reflects in miniature the new hostility towards Osama bin Laden and his methods among some influential clerics abroad; the growing and encouraging revulsion, in the Islamic world, against al-Qaeda's murder of Muslims; the harrying of its cohorts in Afghanistan and Iraq; and the

CIA's recent bullishness about its “war on terror”. But for Britain this progress is only part of the story. Global terror-watchers now regard Britain with pity rather than critical contempt: it still faces the gravest terrorist danger of any Western country.

Britain's peculiar risk was once thought to be its sub-group of alienated second- and third-generation Pakistani immigrants, especially those living in the deprived, semi-ghettoised towns of Yorkshire and Lancashire. The thousands of journeys they make every year to Pakistan are mostly innocent, but sometimes sinister. It is now clear, however, that the problem is more nuanced—and more serious. The terrorists and potential terrorists are foreign as well as home-grown. They may all feel somehow thwarted or humiliated, but they are middle-class and poor, married and single, criminal and respectable. They live in the south-east as well as the north. Compared with, say, their Israeli counterparts—who have a fair idea who their enemies are and where to find them—British security agents face a complex job.

The plots are as varied as the plotters. It can be comforting to think of Islamist terrorism as a single, intelligible foe. But security sources say Britain faces a spectrum of threats, some of which have direct connections to Mr bin Laden's men in the tribal areas of Pakistan whereas others derive nothing more than inspiration from al-Qaeda. The explicit grievance is often foreign policy (Iraq, another reason for Britain's special vulnerability, has unquestionably been a prompt to radicalisation), but sometimes obscurer hatreds are at play (of “slags” in nightclubs, for instance). Some plots are sophisticated; some are amateurish.

And for all the good news about responsible imams and interfaith dialogue, many of the loudest voices within Britain's Muslim communities still belong to strident Islamists, peddling an appealingly simplistic narrative of a worldwide anti-Muslim conspiracy. The more that is known about actual and would-be bombers, the clearer it is that their turn to extremism and finally violence was for many a form of rebellion against stuffy parents. The Islamists, says Mr Husain, are often the “sexiest outfit in town”; unlike other sorts of rebellion, the form they offer looks virtuous too. It is a tough pitch to match.

Not all radicals, of course, are terrorists. But, as Mr Brown has pointed out, at the last count the security services were tracking, or trying to track, at least 2,000 suspects in 200 cells. The numbers are rising—possibly because the spooks have a better handle on their targets, probably also because more *jihadis* are coming forward. The head of MI5 said last year that the danger had not yet peaked. Al-Qaeda proper is patient as well as urgently apocalyptic: it habitually waits years between big operations. There is no reason to think it has forgotten Britain.

Right question, wrong answer

The 42-day debate in parliament this week (see article) would doubtless have been less convulsive if one of the busted plots had succeeded. The government would probably not have had to emasculate its new measures with clumsy compromises. But even in a more febrile, fearful atmosphere, the proposals would have been mistaken. Unglamorous hard work and increased resources are the best ways to contain terrorists, as Mr Brown himself once seemed to realise. The government was half-right though: however relaxed Britons may currently feel, the mega-threat of terrorism will be with them for many years.

Correction: we wrongly stated that the government's counter-terrorism bill scraped through the House of Commons on July 11th. This should have been June 11th. This error was corrected on June 13th 2008

Islam and the West

When religions talk

Jun 12th 2008 | KUALA LUMPUR AND SHARM EL-SHEIKH
From The Economist print edition

Corbis

Religious leaders, scholars and business people are meeting all over the world to argue about free speech and Islamic sensibilities. How much does this achieve?

DEBATES about Islam and the West can throw up unexpected tensions. Take the American and the Brit, successful young professionals who met recently at a seaside resort in Egypt. As it happens, both were devout Muslims who pray five times a day. But as they discovered, manifest piety, of the sort ubiquitous in poorer bits of Egypt, arouses instant suspicion in parts of the country where rich tourists and important Westerners need cocooning—even when those Westerners have come to attend the august deliberations on "Islam and the West" taking place nearby with the blessing of Egypt's government.

The young men's daily supplications were snooped on aggressively by the police and they found themselves longing for the freedom to bow down before God that is taken for granted in California and the English Midlands. Inter-faith encounters, it seems, are tricky enough when they take the form of careful speeches by heads of government and other movers and shakers; for ordinary people who simply want to say their prayers, things can be downright baffling.

That doesn't, and shouldn't, stop faiths from trying to talk to each other. Since Osama bin Laden launched the war he describes as the renewal of an ancient conflict between Islam and the "Crusaders and Jews", there have been many initiatives to head off global confrontations involving religions and the cultures they have spawned. Al-Qaeda's war on the West is by no means the only religious or pseudo-religious dispute in the world. In India, militant Hindus are at odds with other faiths. Sri Lanka's Buddhist monks often support the battle with Tamil separatists. In Northern Ireland and the Balkans, conflict has raged ostensibly between different forms of Christianity.

Recently, however, most of the high-profile efforts to stave off "civilisational" war by talking about it have focused on Islam and the West—without ever answering the question of whether it is useful to treat Islam as a single block, or of whether the West is best defined as Christian, Judaeo-Christian or secular. Perhaps al-Qaeda's proclamation of a civilisational war has been, in part, self-fulfilling: millions of Muslims regard their faith as being in a state of confrontation, along many fronts, with the West. Some Westerners, including prominent and influential ones, return the compliment.

Gabfests galore

Lots to talk about, then. Plenty of people, from theology professors to international-relations wonks, perpetually available to provide services as talkers. And no shortage of business leaders and politicians with an interest in avoiding a complete breakdown in relations between Islam and the West who are the natural supporters of "inter-faith" initiatives. They are often to be found in wealthy and pro-Western

Muslim lands such as Saudi Arabia and other Gulf states, and Malaysia.

One such effort is the “Council of 100 Leaders”, an eclectic group of bishops, rabbis, imams, professors and others established as an adjunct to the World Economic Forum, a Swiss-based organisation. After the attacks of September 11th 2001, it became clear that the forum's stated purposed of “improving the state of the world” would be difficult to achieve without some acknowledgement that religion mattered.

Another effort to bring Islam and the West closer is the “Alliance of Civilisations”, established in 2005 under the United Nations at the urging of Spain and Turkey. Yet another is the Cordoba Initiative (named after the multi-faith world of medieval Andalucia), chaired by Imam Feisal Rauf of New York, a well-connected figure in American Islam. That body and the Malaysian government co-managed a conference on the Muslim world and the West in Kuala Lumpur this week.

All these organisations deal as much with geopolitics and public policy as they do with religion. But there is purely theological dialogue, too. One of the most sophisticated, so far, is the “Common Word”, a letter sent last October to Christian leaders by 138 Muslim scholars.

On a note of gentle provocation, it asked whether the commandments of Jesus to love God and one another could be a basis for conversation between the two largest monotheistic faiths. That initiative was started by the royal house of Jordan, a dynasty that traces its descent to Muhammad yet enjoys close ties to the West. Jordan's royals have also been busy trying to reconcile different branches of Islam, bringing together Sunni and Shia scholars and nudging them to acknowledge one another as fellow Muslims (and hence isolate the ultra-militant types who dismiss as “infidels” any co-religionists with ideas more emollient than their own).

This month, the Saudi royal family also waded into the field, rather to the surprise of Muslim intellectuals in other parts of the world who are exasperated by the narrowness of Saudi theology and embarrassed by the kingdom's total intolerance of other religions. Saudi Arabia's King Abdullah summoned to Mecca some 500 Sunni and Shia scholars for an intra-Muslim debate which was billed as a prelude to a broader discussion between Christians, Muslims and Jews (which will presumably not take place in Mecca, since non-Muslims may not go there).

Almost all such gatherings (and the recent ones in Malaysia and Sharm el-Sheikh in Egypt were no exception) reach the noble conclusion that relations between the world's major faiths, and the countries where they predominate, should not be poisoned by “stereotypes” or “misperceptions” or “prejudice”—and that more effort to combat these dangers should be made in schools, universities, the media and everywhere else. Speakers intone that religious figures might usefully work together on everything from business ethics to global warming.

Elephants in the room

And at almost all these gatherings, there are some huge subjects that participants either do or don't mention, depending on the location, sponsors and audience. One is the Israeli-Palestinian conflict, which hovers in the atmosphere of every discussion involving Jews and Muslims, even when they are ostensibly comparing notes about Abraham, Noah and Moses.

Another is the rise within the Muslim world of various forms of what Olivier Roy, a French scholar, calls “neo-fundamentalism” (often ascribed to a mixture of Egyptian zeal and Saudi petrodollars) which are crowding out local, more compromising readings of Islam in places ranging from the Balkans to south Asia. And of course, lurking in everyone's mind is the question of how much influence reasonable men of the faith have on their unreasonable brothers.

As well as repeating certain familiar commonplaces and negotiating certain familiar taboos, participants in inter-faith gatherings do sometimes run into real questions, that make a difference to the world at large. One such is how, if at all, freedom of speech can be reconciled with the Muslim demand for a ban on public statements or cultural products that offend Islamic sensibilities. At this week's meeting in Malaysia, that question was addressed in a way that frightened the relatively few participants whose understanding of civil rights was rooted in a Western, liberal world-view.

Speaker after speaker called for some formal, internationally agreed restriction on the defamation of religion. “I can never accept that freedom of speech is morally right when it offends my faith,” said Prince Turki al-Faisal, a senior Saudi official (and former head of his country's intelligence service). Several

participants said there should be a legal regime to uphold an article in the International Covenant on Civil and Political Rights (a UN treaty that came into force in 1976) which states that “any advocacy of national, racial or religious hatred that constitutes incitement to discrimination, hostility or violence shall be prohibited by law.”

Put like that, the proposition sounds reasonable. But it can easily turn into a censor's charter. In Britain, for example, a new law outlawing “religious hatred” would have made it impossible—at least in its early version—to express strong disagreement with the tenets of any faith. Western civil libertarians are extremely nervous of any national law, let alone international regime, that formally restricts free speech on religious matters.

Fuelling all such discussion is the unavoidable fact that in an age of instant communications, offences to Muslim sensitivity, such as the cartoons of the Prophet Muhammad published in a Danish newspaper, can easily trigger a global chain reaction, causing everything from murderous riots in Pakistan to a collapse of European exports to Muslim countries. Adding further to the tension—and an element of this week's debates in Kuala Lumpur—is the increasingly well-co-ordinated campaign by the Organisation of the Islamic Conference to redefine human rights in a way that explicitly outlaws the defamation of religion.

But in the midst of a tetchy discussion, one voice did defend the Western understanding of democracy and civil liberty, and indeed the compatibility of those principles with the devout practice of Islam. It came not from any of the government officials present (including those from Britain, France, Spain and Australia) but from a young Dutch Muslim lawyer.

Fatma v Fitna

Famile Fatma Arslan explained to a roomful of mostly male dignitaries that there might be better ways of defending Islam in the West than trying to impose in Western countries the curbs on free speech that exist in most Muslim lands. She described how she and her friends used the avenues offered by Dutch democracy to express their objections to an anti-Muslim film, “Fitna”, made recently by a member of parliament, Geert Wilders.

Through sermons in every Dutch mosque, plus public meetings and educational events, she reported it was emphasised again and again that democracy gave people the chance to argue in favour of Islam, as well as against it. People were urged not to play into the hands of anti-Muslim extremists by reacting in a violent or intemperate way. And in part because of these efforts, the sort of Christian-Muslim violence that has erupted several times in recent Dutch history was avoided.

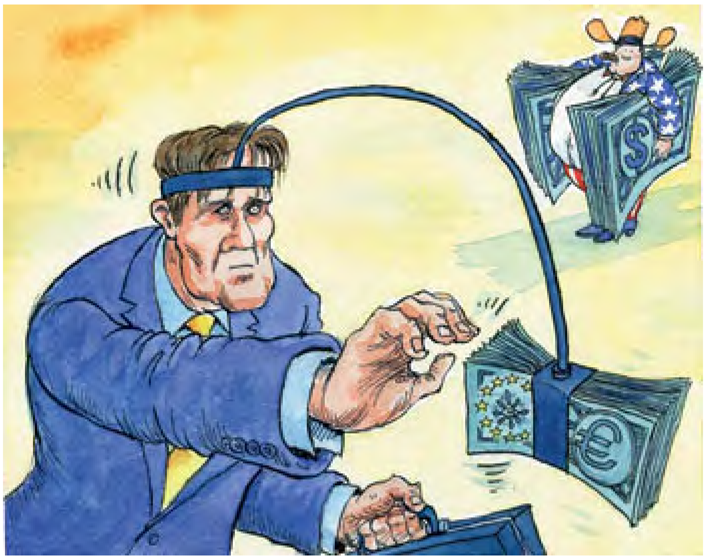
“It's a great time to be a European Muslim,” insisted Ms Arslan, who was born in Diyarbakir in eastern Turkey but clearly relishes everything that her adopted homeland has given her: the freedom to cover her head and to pray wherever and in whatever way her conscience impels her, with no interference from the police. If there is a problem between Islam and the West, people like her are surely part of the answer.

Executive pay in Europe

Pay attention

Jun 12th 2008 | PARIS
From The Economist print edition

Illustration by David Simonds



European politicians have declared war on “excessive” executive pay—but companies are more prudent than they think

AT THE height of his career at Vinci, a French construction giant, Antoine Zacharias, its chairman, had a salary of several millions, a lavish pension and stock options worth €250m. On one occasion the French financial police visited Vinci's headquarters to investigate the firm's purchase of furniture for a luxurious Paris townhouse bought for his use. In 2006 Mr Zacharias was forced out and left with a generous severance package, but he sued the company for €81m for allegedly preventing him from exercising some stock options. The case, notorious in France, was finally closed two weeks ago when a court ruled against him.

Bosses in Europe should take heed. Even when performance is outstanding—Vinci's shares went up ninefold during Mr Zacharias's nine years at the top of the firm, and its revenues more than tripled, to €26 billion ($33 billion)—opinion has turned squarely against big pay packages. Jean-Claude Juncker, president of the European Commission's “Eurogroup” of finance ministers, recently called excessive pay a “social scourge” and demanded action. When *L'Expansion*, a French business magazine, calculated that pay for the country's bosses went up 58% in 2007, the finance minister, Christine Lagarde, said it was “scandalous” and threatened regulation. Nicolas Sarkozy, president of France, and Horst Köhler, president of Germany, have also denounced high pay.

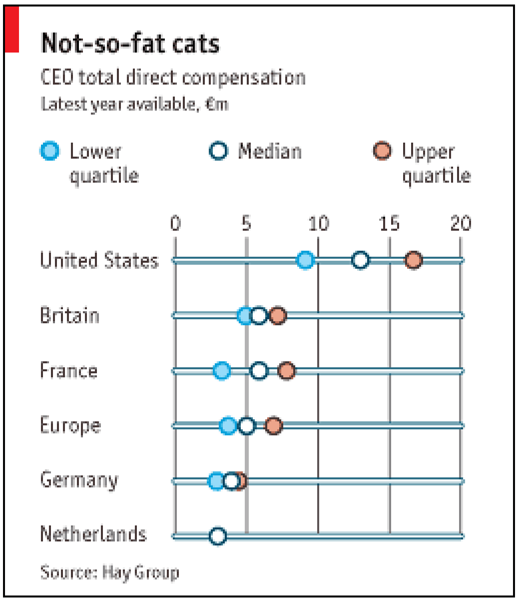
“If we go into a major recession with job losses, but top executives are still being paid huge sums, that's bad for the reputation of capitalism,” says Peter Montagnon, director of investment affairs at the Association of British Insurers. Banks in particular have come in for criticism. Not only are they blamed for the credit crunch, but some, such as Switzerland's UBS, have admitted that the way in which they rewarded senior employees led them to take greater risks, resulting in huge losses on subprime mortgages.

Already in the Netherlands new legislation on executive pay is making its way through parliament. The law would set €500,000 as the level of annual salary or severance payment at which extra taxes must be paid. Germany's Social Democratic Party is pushing for legislation to clamp down on pay, though its partner in government, Angela Merkel's Christian Democratic Union, has so far resisted. And the European Commission is working on a response to the Eurogroup's complaint.

How excessive is bosses' pay in Europe? It has certainly risen sharply in the past ten years, as European

firms have had to compete globally for talent. Foreign bosses now run seven of the firms in France's CAC 40 index and five of Germany's DAX 30. American-style bonuses and long-term incentive plans are now the norm.

European firms now benchmark pay against international peer groups in their own industries, rather than against domestic rivals, according to Piia Pilv, a pay expert at Mercer, a consultancy. But they still pay a fraction of the sums trousered each year by American executives. According to Hay Group, a management consultancy, the median European executive earns just 40% as much as his equivalent in America (see chart).



Most importantly, European companies appear to be more determined than American ones to link pay to performance. "Firms in Europe have tended to put more stringent conditions on long-term incentive awards than in America," says Richard Bednarek, global director of executive remuneration for Hay Group. In America grants of shares are often not tied to performance, whereas European firms generally attach performance criteria to any grant of shares, typically depending on a comparison with a peer group. Such schemes often do not pay out at all, says Mr Bednarek. Dan Vasella, boss of Novartis, a Swiss pharmaceutical giant, and a favourite target of pay activists, earned SFr17m ($14m) in 2007, down 33% from 2006, because he missed his targets.

Last year France introduced a new measure, unheard of elsewhere, which makes severance payments conditional on performance. Usually only bonuses and long-term incentive plans are tied to results. At the end of May, to comply with the law, Alcatel-Lucent, a maker of telecoms gear, changed its contract with its chief executive, Patricia Russo. If she leaves or is fired after January 2009, she will get her severance money only if the firm achieves 90% of its revenue target or 75% of its operating-profit target during the period. Remuneration consultants complain that the law could make it harder for companies to get rid of underperforming chief executives. But it is undeserved "golden parachutes" that enrage public opinion the most, and the government wants to stamp them out.

Big differences in pay persist between European markets. Companies in Scandinavian countries and in the Netherlands, which are particularly egalitarian, usually pay less than French, German or British firms. Britain and France make use of stock options, whereas firms elsewhere prefer to give "free" shares. Use of stock options, never so widespread in Europe as in America, is in fact declining in most countries. Another trend is for publicly listed firms to copy private equity's pay structure, to avoid losing the best people, according to Mercer. Executives make a big private investment in the firm, but gain many multiples of their annual salary if they meet extremely high performance criteria.

Few shareholders are unhappy with the increase in executive pay in Europe, says Jean-Nicolas Caprasse, head of European corporate-governance research at RiskMetrics Group, which advises institutions on how to vote at annual general meetings. They are gradually winning more say over pay deals, as in America (see article). By law in the Netherlands, Sweden and Norway, shareholders get a binding vote on compensation packages; in Britain they get a non-binding vote. Some Spanish and Swiss firms are voluntarily starting to offer shareholders a vote.

In Britain, where "say on pay" has been in place since 2004, says Mr Montagnon, shareholders now have a far better understanding of the structure of executive pay packages and their link with performance. "But nothing stops the volume of payments, and the amounts seem to rise inexorably," he says. It is near impossible, of course, to determine the correct absolute level of executive pay. Shareholders will find it hard to prevent headline-grabbing paydays, even if they wanted to. So expect further political outrage, and more red-faced bosses coming under fire.

Say on pay in America

Fair or foul?

Jun 12th 2008 | NEW YORK
From The Economist print edition

Shareholders in America want more influence over bosses' pay

OPPONENTS of Croesus-like rewards for America's top bosses got a boost from an unlikely source this week. In a speech on June 10th John McCain, the Republican presidential candidate, railed against the iniquities of “extravagant” pay and severance deals. And he promised to force companies to seek shareholder approval for their executive-pay schemes if he wins in November.

This delighted investors fighting for more say over bosses' pay and perks. RiskMetrics, a consultancy, reckons 70 “say on pay” resolutions will be tabled in 2008 asking American firms to give investors non-binding votes on compensation plans, up from 52 in 2007. So far this year such motions have won majority support at seven firms, including Apple and Motorola. In May Aflac, a health insurer, became America's first public company to hold a formal vote on its pay plan, which won 93% approval.

Peter Oppermann of Mercer, a consultancy, points out that most resolutions that seek to put in place such votes have been defeated, however. Critics argue, amongst other things, that simple yes-or-no decisions are no way to treat complex compensation matters, and that investors who are really unhappy with a proposed plan should just vote out the directors responsible for it.

Neither argument is convincing. Most institutional shareholders have the know-how to judge if plans are in their interest, or can hire outside experts to do so. They negotiate with companies over pay long before the company meeting—using the threat of defeat in a vote for leverage. And ousting otherwise competent directors, without warning, over pay seems extreme. Richard Ferlauto of the American Federation of State, County and Municipal Employees, one of the main proponents of say-on-pay votes, likens a negative vote to the yellow card that a referee shows an errant soccer player. The player knows that if he transgresses again he will be sent off. By the same token, a public warning may give directors the incentive they need to overhaul a firm's pay policy.

If Mr McCain is elected and keeps his promise, boards will have no choice but to listen to shareholders on pay. His Democratic rival, Barack Obama, who has sponsored a bill in Congress that supports say-on-pay votes, may also take a tougher line if he wins. Voluntary action by companies to introduce say-on-pay votes could head off government intervention. Firms that resist may end up scoring an own goal.

Apple

Follow the leader

Jun 12th 2008 | SAN FRANCISCO
From The Economist print edition

Apple ditches its unusual business model to boost handset sales

ALMOST a year after launching what he thinks is the phone to change all phones, Steve Jobs, the boss of Apple, took to the stage again this week to introduce its second version, the iPhone 3G. In the past year Mr Jobs, who had surgery for pancreatic cancer in 2004, has visibly aged. Looking emaciated, he farmed out large parts of his speech, which is usually a big marketing and media event, to other presenters. But he still held the crowd in thrall as ever.

The new iPhone mostly addresses the shortcomings of the old one. It has GPS satellite-positioning technology that will allow a new and exciting category of services, such as location tracking, that depend upon the phone knowing where it is. It works with fast third-generation (3G) mobile networks, not just slower 2G ones. And it panders to corporate customers with features such as better integration with their systems and "remote wiping" of data if a handset goes missing.

Perhaps above all, it is a lot cheaper, starting at $199, just below what the industry sees as the pain threshold for the mass market. What Mr Jobs did not say was that the reduction comes largely from a change in Apple's relations with mobile operators, such as AT&T in America. Operators will subsidise the new handsets to make this low price possible, but will also increase monthly usage fees—and will no longer pass a share of those fees to Apple.

This brings Apple in line with the business model used by other handset-makers, such as Nokia and Samsung. Getting operators to agree to Apple's novel revenue-sharing scheme seems to have hindered sales. Evidently Mr Jobs hopes to gain more from faster handset sales than he will lose by giving up his share of usage fees. By cutting the iPhone's price and increasing the number of countries where it is legally available from six to 70, Mr Jobs hopes to reach his goal of selling 10m iPhones by the end of the year. (So far, 6m have been sold.)

Competitors quickly tried to douse another conflagration of iPhone hype. "I see this as a catch-up release for Apple," says Andrew Lees, head of mobile businesses at Microsoft, an arch-rival which provides software to many handset-makers. "We outsell them by two to one." He points out, legitimately, that many phones using Microsoft Mobile software have long had both GPS and 3G, and have always tied into corporate computer systems.

Finland's Nokia sells the most "smartphones", capturing 45% of the world market in the first three months of this year, and Canada's Research In Motion (RIM), the maker of the famous BlackBerry, is second, with 13%. Even in America, where Nokia is weak, RIM leads, with 42%, followed by Apple with 20%.

But Apple's impact on the industry has been greater than its market share suggests. The iPhone has set new standards in design and ease of use. A telling statistic from Mr Jobs is that 98% of users browse the web on their iPhones, 94% use it for e-mail, and 80% use ten or more features—including, of course, the built-in iPod music-player. As Mr Jobs joked, many users of other smartphones, with their clunky menus, cannot even find ten features.

This points to the ultimate role of the iPhone for Mr Jobs, Apple and the industry. There were personal computers before 1984, but it took the Macintosh, which Apple launched that year, to popularise the icon-based graphical interface that others copied, kicking off the PC era. There were digital music-players before 2001, but Apple's iPod made them both ubiquitous and user-friendly. In the same way, says Tim Bajarin of Creative Strategies, an analyst who has followed Apple throughout its history, the iPhone, with its elegant touch-screen interface, seems likely to be the gadget that sets the direction that others will follow in the era of mobility.

To bring that about, Apple is now turning the iPhone into a hand-held computer and allowing other firms to write software to run on it. Other handset-makers are doing the same, but the iPhone's operating system and programming tools, on display this week, are better than theirs. There is no doubt that Mr Jobs is trying to lead a third revolution in consumer technology in his lifetime.

Europe's energy market

Better than nothing?

Jun 12th 2008
From The Economist print edition

A muddled compromise in Europe's attempt to reform its energy markets

WHEN decision-makers call a new policy a “third way” it usually signals an unsatisfactory compromise. That is certainly true of the proposed energy-policy rules agreed on by European Union (EU) energy ministers in Luxembourg on June 6th. Andris Piebalgs, the EU energy commissioner, had set out to force governments to separate or “unbundle” energy companies' production and transmission assets. What he has achieved with the legislative proposal is a hybrid system that lets governments choose between mandating a proper break-up of their country's vertically integrated energy giants, and two watered-down forms of separation.

By his own admission Mr Piebalgs has “mixed feelings” about the compromise in the draft legislation that will now be submitted to parliamentarians. But he is under pressure from two rival factions. Britain, Spain, the Netherlands and the Scandinavians champion “Independent Transmission System Operation” (ITSO), which is jargon for full unbundling. In their view vertically integrated companies such as France's EDF and Germany's RWE and e.ON shut rivals out of their transmission systems and shy away from reinvesting their profits in network improvements.

As an alternative to ITSO the Commission also proposed a watered-down version, allowing companies to retain ownership of their spun-off networks. But even that was too much for a group of eight countries, led by France and Germany, which say that “effective and efficient” unbundling of transmission systems does not require such separation. This group proposed a “third way” that merely requires companies to have independent management teams for generation and transmission, and to boost investment. National governments will be able to decide which of these three options to adopt.

The Commission insists that it has made progress on other fronts. A new “Agency for the Co-operation of Energy Regulators” is to oversee the functioning of energy markets, notably in cross-border co-operation between network operators. But Dieter Helm, an expert on energy regulation at Oxford University, says there is not much to celebrate. He argues that the proposal is a muddled compromise that will create cumbersome regulation and more bureaucracy. In his view unbundling should have been pushed through in the 1990s, when energy prices were low, investment requirements were negligible and supply was abundant. Unbundling seems much less important today, he says.

Instead, as Russia becomes an increasingly powerful energy producer, the EU should focus on safeguarding its security of supply, in particular by forming a common front in dealings with Gazprom and other Russian energy giants. By 2030 Russia will provide about 50% of the EU's gas imports. Yet rather than working together, countries are striking bilateral deals with Russia. Combating climate change should be the EU's second priority. Talks are being held at regular intervals, but so far unrealistic targets for the use of renewable energy have been the main result. “European energy policy has been a substantive failure,” says Mr Helm.

The Commission says it had to agree on a compromise. France, an opponent of full unbundling, will take over the EU's rotating presidency on July 1st, so the reformers had to get things sorted out this month. And the new policy may yet help to foster a more unified external energy policy through the new pan-European agency and increased co-operation among network operators. But implementation will take at least two years. Meanwhile, Europe's vertically integrated giants—especially Germany's RWE and e.ON—will pursue their own foreign energy policy. And governments will do their very best to help their national champions.

Porsche and Volkswagen

See you in court

Jun 12th 2008 | FRANKFURT
From The Economist print edition

Everyone connected with Volkswagen calls in the lawyers

PORSCHE, a profitable maker of sports cars in Stuttgart, and the European Commission, guardian of the Europe Union's internal market, are unlikely allies. But both have recently renewed efforts to strip Volkswagen (VW), Europe's biggest carmaker, of the protective barriers enshrined in a law in 1960. Last October the European Court ruled that the VW law had to go. The German government, the Land of Lower Saxony and VW itself are fighting a rearguard action to keep one bit of it intact: Lower Saxony's right to veto board decisions, even though it has only 20.3% of the voting rights (the usual blocking minority is 25% under German law).

An amended VW law, passed by the German cabinet last month, retains the veto, which would protect the company against unpopular measures such as closing factories in Germany. That prompted the European Commission to open infringement proceedings on June 5th. Germany has two months to respond. Rather lamely, it has added a protocol to the amended law making further changes negotiable—a better prospect, perhaps, than facing fines of up to €100,000 ($155,000) a day. Porsche is happy to see pressure applied to VW and the government. It has a 31% stake in VW, which it says it will raise to over 50% by the end of the year. Its plan is to bring VW under the wing of its holding company.

But lawsuits have been flying within Germany too. Porsche and Lower Saxony are at loggerheads over VW's articles which, like the law, allow a veto with 20% plus one share. Porsche's lawyers say this is illegal and are suing VW in Braunschweig in Lower Saxony. Lower Saxony has asked a Hanover court to give an independent ruling. Meanwhile VW workers' representatives are suing Porsche in Stuttgart for exercising dominance over VW by offering Porsche's much smaller workforce—12,000 compared with VW's 330,000—equal say on the holding company's supervisory board. A first opinion by the court says Porsche, with its 31% stake, is not dominant—yet.

But there is no doubt that powerful egos at Porsche are preparing to shake things up at VW. Three of them, besides Ferdinand Piëch, VW's chairman, sit on the supervisory board. They include Wendelin Wiedeking, Porsche's punchy chief executive, a renowned cost-cutter; Holger Härter, its finance director, who is credited with making €4.5 billion for Porsche so far on positions in VW shares; and Wolfgang Porsche, head of the Porsche clan. Together the Porsches and Piëchs own 100% of Porsche's voting rights. Their common ancestor, Ferdinand Porsche, designed the first VW for Hitler in 1934 and rolled out the first Porsche sports car in 1948.

Wolfgang Porsche's star has been rising recently, after years in the shadow of his cousin Mr Piëch, with a cover story in one magazine and a joint interview with Mr Piëch in another. Old tensions within the family seem to have eased as it makes a bold move for greater scale. “Porsche is too small,” Mr Porsche told one interviewer.

The conflict of interest between Porsche and VW is clear. Porsche is a competitor of Audi, a VW subsidiary which makes some sporty cars. Martin Winterkorn, VW's chief executive, has threatened to resign if Porsche interferes. Hailed as a white knight when it came in three years ago to rescue VW from potential foreign predators, Porsche is now seen by many, especially in VW's base in Wolfsburg, as a predator. Porsche executives have been warned that their Cayennes and Carreras risk more than a few scratches in the Wolfsburg car park.

Beer

Hands off our Bud

Jun 12th 2008 | NEW YORK
From The Economist print edition

Never mind the Chinese—here come the Belgians

COULD anything symbolise America's loss of economic supremacy more clearly than for its favourite beer to fall into foreign hands? Hitherto, Budweiser has been at the forefront of the Americanisation of the world, often to the dismay of foreign drinkers of traditional beers who regard a Bud as a glass of water spoiled. On June 9th it was announced that Budweiser would go on sale in Vietnam, its latest advance into a new foreign market. Yet just two days later a foreign bidder tabled an unsolicited bid worth $46 billion for Budweiser's brewer, Anheuser-Busch.

Rumours of an impending bid from InBev, a Belgian brewer, had been circling for weeks, pushing up Anheuser-Busch's share price, albeit not close to the $65 a share that InBev has offered. The deal has plenty of attractions to both firms, though Anheuser-Busch has yet to indicate whether it is interested in selling. The founding Busch family now owns around 4% of the firm, and is reportedly somewhat divided over a sale. Warren Buffett's Berkshire Hathaway, which owns 5% of the brewer, is likely to make the decision on price alone.

The acquisition would give InBev better distribution for beers such as Beck's and Stella Artois in America, where, despite being the world's second-largest brewer, it has only a tiny presence. Sales of mass-market beers have been weak of late, as microbreweries and premium beers have taken market share, which bodes well for InBev's European lagers.

Meanwhile, consolidation among its domestic competitors has lately intensified the pressure on Anheuser-Busch, the world's third-biggest brewer. On June 6th antitrust clearance was received for a joint venture combining the American operations of SABMiller and Molson Coors, which between them account for some 30% of American beer sales. (Anheuser-Busch's market share in America is roughly 50%.)

Given the recent rise in protectionist sentiment in America, the immediate public outcry at this foreign assault on the country's King of Beers comes as no surprise, even if Belgians are a lot less scary than the Chinese to Joe Couchpotato. Already, the *Jacksonville Business Journal* has found 80% of respondents in its online survey wanted Anheuser-Busch to remain in American hands. In fact, InBev's impressive distribution network outside America would probably lead to a sharp increase in the number of foreigners guzzling Bud. So, as the stars of one popular Bud advert might ask, “Wassup?”

Private education

The Swedish model

Jun 12th 2008 | STOCKHOLM
From The Economist print edition

A Swedish firm has worked out how to make money running free schools

BIG-STATE, social-democratic Sweden seems an odd place to look for a free-market revolution. Yet that is what is under way in the country's schools. Reforms that came into force in 1994 allow pretty much anyone who satisfies basic standards to open a new school and take in children at the state's expense. The local municipality must pay the school what it would have spent educating each child itself—a sum of SKr48,000-70,000 ($8,000-12,000) a year, depending on the child's age and the school's location. Children must be admitted on a first-come, first-served basis—there must be no religious requirements or entrance exams. Nothing extra can be charged for, but making a profit is fine.

Kunskapsporten

Flatpack schooling

The reforms were controversial, especially within the Social Democratic Party, then in one of its rare spells in opposition. They would have been even more controversial had it been realised just how popular they would prove. In just 14 years the share of Swedish children educated privately has risen from a fraction of a percent to more than 10%.

At the time, it was assumed that most “free” schools would be foreign-language (English, Finnish or Estonian) or religious, or perhaps run by groups of parents in rural areas clubbing together to keep a local school alive. What no one predicted was the emergence of chains of schools. Yet that is where much of the growth in independent education has come from. Sweden's Independent Schools Association has ten members that run more than six schools, and five that run ten or more.

The biggest, Kunskapsskolan (“Knowledge Schools”) opened its first six schools in 2000. Four more opened last autumn, bringing the total to 30. It now has 700 employees and teaches nearly 10,000 pupils, with an operating profit of SKr62m last year on a turnover of SKr655m.

Like IKEA, a giant Swedish furniture-maker, Kunskapsskolan gets its customers to do much of the work themselves. The vital tool, though, is not an Allen key but the Kunskapsporten (“Knowledge Portal”), a website containing the entire syllabus. Youngsters spend 15 minutes each week with a tutor, reviewing the past week's progress and agreeing on goals and a timetable for the next one. This will include classes and lectures, but also a great deal of independent or small-group study. The Kunskapsporten allows each student to work at his own level, and spend less or more time on each subject, depending on his strengths and weakness. Each subject is divided into 35 steps. Students who reach step 25 graduate with a pass; those who make it to step 30 or 35 gain, respectively, a merit or distinction.

Again like IKEA, no money is wasted on fancy surroundings. Kunskapsskolan Enskede, a school for 11- to 16-year-olds in a suburb of Stockholm, is a former office block into which classrooms, open-study spaces

and two small lecture-theatres have been squeezed (pictured). It is pleasant, but basic and rather bare. It rents fields nearby for football and basketball, and, like other schools in the chain, sends pupils away to one of two specially built facilities for a week each term for home economics, woodwork and art, rather than providing costly, little-used facilities in the school.

Teachers update and add new material to the website during school holidays and get just seven weeks off each year, roughly the same as the average Swedish office worker. “We don't want teachers preparing lessons during term-time,” says Per Ledin, the company's boss. “Instead we steal that preparation time, and use it so they can spend more time with students.”

Many schools would be horrified to be likened to IKEA, but Mr Ledin goes one better. “We do not mind being compared to McDonald's,” he says. “If we're religious about anything, it's standardisation. We tell our teachers it is more important to do things the same way than to do them well.” He then broadens the analogy to hotels and airlines, which make money only if they are popular enough to maintain high occupancy rates.

One selling point that any parent of a monosyllabic teenager will appreciate is the amount of information they will receive. Each child's progress is reported each week in a logbook, and parents can follow what is being studied on the website. And the braver among them will be keen on the expectation that the children take responsibility for their own progress. “Our aim is that by the time students finish school, they can set their own learning goals,” says Christian Wetell, head teacher at Kunskapsskolan Enskede. “Three or four students in each year may not manage this, but most will.”

Performance monitoring is also important within the company: it tracks the performance of individual teachers to see which ones do best as personal tutors or as subject teachers. It offers bonuses to particularly successful teachers and is considering paying extra to good ones from successful schools who are willing to move to underperforming ones.

Kunskapsskolan's do-it-yourself style of education may soon be available outside its home country. In March it was named preferred bidder to run two “academies”—state-funded schools run largely free from state control—in London. If they go ahead (negotiations with the government are proving fraught), they will be run by a not-for-profit arm, since for-profit ventures are banned from Britain's academies programme. The firm also hopes to open low-cost independent schools in Britain, where it can offer the full Kunskapsskolan experience, free of state meddling.

Lessons for politicians

Schooling is, in one respect, a very safe business: parents will always want their children educated and future demand is relatively easy to predict. So unsurprisingly the returns are solid, rather than stellar: Mr Ledin quotes an average return on capital of 5-7% a year. But like any business with a single customer, there are risks, too—and when that customer is the state, the biggest ones are political. If a future government, hostile to school choice, changed the rules, that would be the end of this nascent market.

Carl-Gustaf Stawström, the managing director of Sweden's Independent Schools Association, is sanguine. The school reforms are popular with parents, he says, and politicians know they meddle with them at their peril. More plausible would be a change to the rules so that independent schools had to match the methods and curriculum of state schools more closely, or perhaps even a ban on profits.

The latter sounds bad, says Mr Stawström, but would not really amount to much: companies could split themselves into non-profit schools and a profit-making body that supplies services, such as teaching materials and consultancy. And as for competing head-to-head with the state? “We have independent schools now that are sure they can compete on the same ground. They are just very good.”

Face value

From across the divide

Jun 12th 2008
From The Economist print edition

Europe's biotech firms need to think big if they are to prosper, says Lisa Drakeman of Genmab

Reuters

IS EUROPE'S biotechnology industry finally ready for the big time? For decades the continent's scientific elite watched as boffins in America fled academia to start biotech firms. European governments poured billions of euros into “technology corridors”, “pôles de compétitivité”, and other top-down schemes to create biotech clusters. But most of the venture capital still went to American firms, and Europe failed to produce a rival to America's Amgen or Genentech. Defenders of Europe's efforts to promote innovation in biotechnology noisily object to this view. To show that Europe's efforts may at last be paying off, they point to a recent uptick in investment—and to Genmab, a Danish firm led by Lisa Drakeman. And what does she think? Hers is an unusual perspective, for as well as being boss of one of Europe's biggest biotech firms, Ms Drakeman is American.

Ms Drakeman calls herself an “accidental CEO” because she came to her job via an unusual route. After a doctorate at Princeton in the history of religion, she went to work at Medarex, an American biotech firm that her husband was just getting off the ground in the 1980s. It went public in 1991, and Ms Drakeman moved into business-development in 1993. She spotted an opening, based on the work of a Dutch scientist who was advising Medarex, and proposed to set up a company. But American venture capitalists were unwilling to back the idea. Instead a Danish investor, BankInvest, came forward—and proposed that Ms Drakeman herself should lead it. So Genmab was set up in Copenhagen, though its research facilities are in the Netherlands.

The company went public in 2000, and is listed in Copenhagen. Today it has a market value of some $2.5 billion, making it one of the world's top 20 biotech firms. What makes this valuation even more striking is that Genmab has spent some $300m-400m of investors' money, but still has no products for sale—and therefore no reliable stream of revenues. Ms Drakeman says its value is a sign that investors believe in the drugs it has in clinical trials—such as ofatumumab, a cancer and arthritis drug in late-stage clinical trials, which she reckons could eventually have annual sales of $5 billion. In late 2006 GlaxoSmithKline, a British drugs giant, agreed to a record-breaking licensing deal for the drug, paying $357m for a 10% stake in Genmab and offering “milestone payments” worth up to $1.6 billion provided the drug meets expectations as it inches towards the market.

All this comes as broader investment trends also seem to favour Europe's biotech firms. Ernst & Young, a consultancy, estimates that the total value of mergers and acquisitions in Europe's biotech industry leapt from €2 billion ($2.5 billion) in 2006 to nearly €15 billion last year. Listed firms have also been doing better, “suggesting that after years of lacklustre growth the European sector is sustaining robust financial

performance."

Unfortunately, Ms Drakeman's experience says as much about the failings of European biotech as it does about its potential. Indeed, Genmab's success arises from her willingness to thumb her nose at European chauvinism and to position Genmab as an embryonic global powerhouse, with aspirations in all big markets. "Genmab is not a European biotech firm, we are a global firm," she says. A common criticism is that European technology start-ups fail to think big in contrast with the outsized egos in Silicon Valley. Georges Haour of IMD, a Swiss business-school, calls this Europe's "Peter Pan complex"—promising firms do not become world-beaters because they do not grow up.

Ms Drakeman encountered European parochialism when raising investment capital for the company abroad (today some 40% of her shareholders are American institutional investors). Some of her Danish investors were very upset when she brought these other investors on board. "'Why do you need so much money now,' they asked, insisting that they would have been ready to provide us with more money eventually, when they decided that we needed it," she says. She decries this lack of ambition and argues that her firm's brimming portfolio of drugs, never mind its stunningly lucrative deal with GSK, would not have been possible if she had stayed put in Copenhagen.

Indeed, she confides that much of the GSK deal was actually done not in Britain or Denmark, but in Philadelphia (home of Jean-Pierre Garnier, boss of GSK until last month) and Princeton, where Ms Drakeman is now based. Having lived in Denmark for several years, while her husband continued to live in America, Ms Drakeman moved back to Princeton in order to see more of her family, to be closer to American investors and to escape Denmark's punitive tax regime. She points out that America's research clusters in California and Cambridge, Massachusetts are attracting talent from many European firms, challenging the notion that European biotech is somehow about to break free of the constraints that have long held it back.

Keeping the faith

That points to some snags in the Genmab story. Its R&D is still anchored in the Netherlands, where its star researcher is based. What if he leaves, or refuses to move to a new American research headquarters? More troublingly, what if one of Genmab's potential blockbusters fails late in the game—as did Pfizer's torcetrapib, a cholesterol drug that cost the firm $1 billion? A drugs giant is big enough to survive such a huge blow, as Pfizer has shown, but such a fiasco would surely wipe out a start-up like Genmab. Yet Ms Drakeman insists that investing in biotech is not as random as all that. A good boss can guide a firm, she reckons, by identifying what the market needs, securing the edge in intellectual property and maintaining the confidence of investors—especially if there are not yet any revenues. It seems that Ms Drakeman's doctorate came in handy after all: having studied the history of religion, she knows all about how to persuade people of the need to have faith.

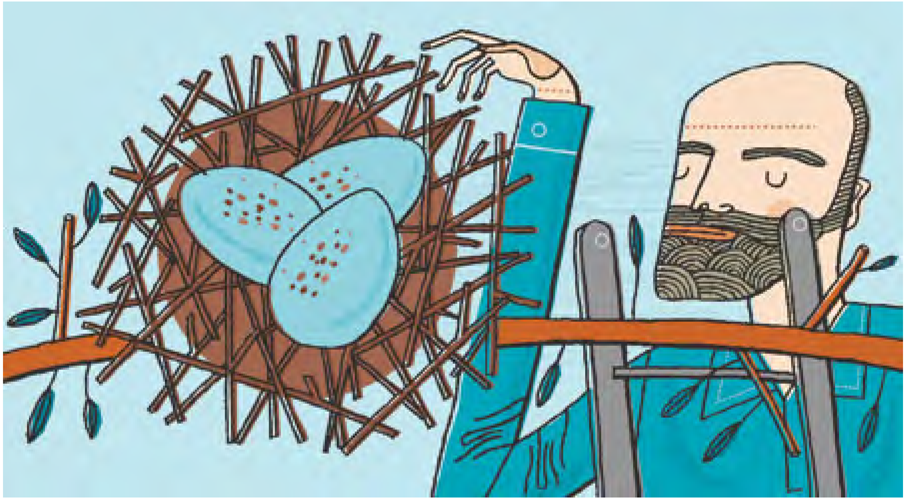
Economist.com FINANCE & ECONOMICS

The trouble with pensions

Falling short

Jun 12th 2008
From The Economist print edition

Illustration by Robin Chevalier



Workers are sleepwalking towards an impoverished old age

MORE and more people are speculating on their retirement income, even though they may not know it. According to Watson Wyatt, an actuarial consultancy, the amount of money that is saved in defined-contribution (or money-purchase) schemes worldwide will overtake the amount of money in defined-benefit (or final-salary) schemes by 2014—see chart 1.

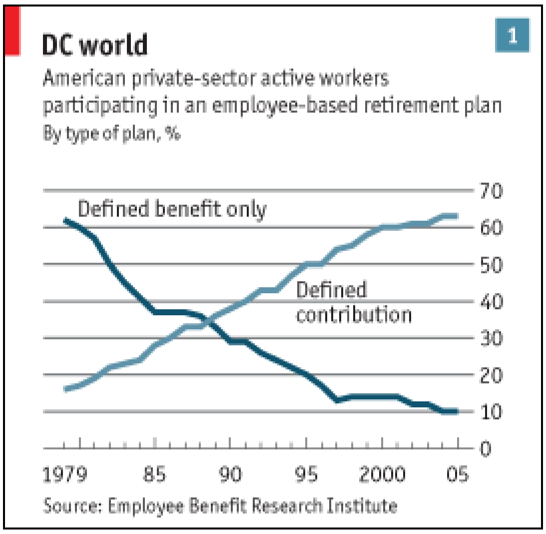
For a lot of people, this is going to be a problem. In a defined-contribution (DC) scheme, the eventual pension depends on the investment performance of the fund that the employee has paid into—and he takes the risk of poor investment performance. By contrast, defined-benefit (DB) schemes promise employees a retirement income based on their pay and length of service. The employer takes the risk.

But an even bigger problem is that the level of contributions from both employers and employees into DC schemes is lower than it is into DB schemes. Whatever the arguments about the merits of the new wave of schemes, if you put less money in, you will get less money out. To make the shortfall worse, the costs of running DC schemes are, on average, higher. And finally, DC pensions call for a degree of decision-making that their members are often ill-equipped to undertake. As a recent paper* published by Britain's Pensions Institute points out: for "financial products extending over long periods of time, many consumers are clearly not well-informed or well-educated. The retirement-savings decision needs accurate forecasts of lifetime earnings, asset returns, interest rates, tax rates, inflation and longevity; yet very few people have the skills to produce such forecasts."

The result may be that many employees face retirement with an income well short of their expectations. An employee who pays into a DC scheme for 40 years may get only half the retirement income he could have expected under a final-salary system. When pension experts were polled by Watson Wyatt their biggest concern was that DC schemes will yield inadequate pensions for DC members. As the Pensions Institute paper says: "When the plan member eventually discovers how low his pension really is, it is by then too late to do anything about it."

If pension incomes are too small, employers will face the problem that their older, and usually more expensive, workers are unwilling or unable to retire; firing them may not be an option in places such as Britain, that have laws against age discrimination. Even when employees do retire with a decent pot of money, many countries, including America, Germany and

Australia, do not require the pensioner to convert those savings into an annuity. That creates the risk that the pensioner will outlive his savings, prompting him to fall back on the mercy of the state. Indeed, the evidence suggests that employees are not good at estimating how long they are likely to live.



Whatever the flaws of DC schemes, the world—or at least the private sector—is not about to return to DB plans. Companies introduced DB plans after the second world war as a benefit for employees—sometimes as a way of heading off demands for higher wages.

Initially, the costs of this promise were manageable, largely because companies could decide whether to raise the pension of someone in retirement. Steadily, however, the promise of a DB pension became more expensive. For example, British schemes were forced to protect employees against the ravages of inflation. Longer lives also added to the burden.

The bull market of 1982-2000 disguised this, as investment returns outpaced the rise in pension liabilities for a long while. But the cost eventually came to seem intolerable, because of a combination of the bear market of 2000-03, falling interest rates, and a change to accounting standards, which asked firms to report the annual change in their pensions burden.

DC schemes have been around for 30 years or so, and were at first widely used by the self-employed and small businesses. Such schemes promise nothing. Although employers usually contribute to them, they do not have to top up the fund if its returns are disappointing.

DB or not DB

Enthusiasts for DC pensions argued that the investment risk was at least partly offset, since a DC member avoided the “credit risk”—that the company would go bust before fully funding its pension plan. However, in Britain and America credit risk is less of a factor these days, since insurance schemes now protect employees from the bankruptcy of the sponsoring company. And changes to DB rules have reduced the penalties on early leavers (albeit at the price of making the schemes more costly to run, and thus more likely to be closed).

Nevertheless, there is a strong argument that companies should not be offering DB schemes. Since the schemes require companies to take bets on the financial markets, it turns firms into quasi-hedge funds and distracts them from their core business. The DC approach allows businesses to stick to their knitting.

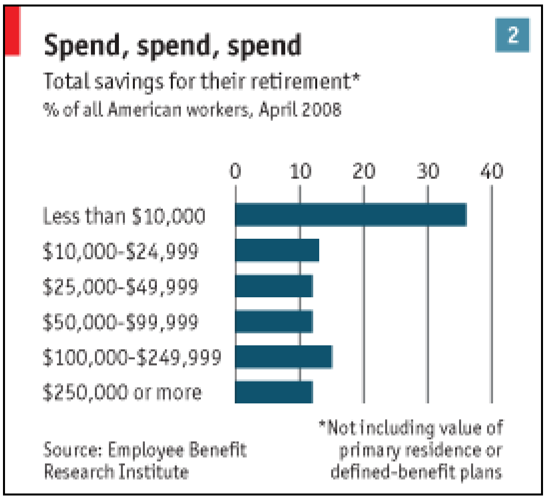
In addition, DC pensions arguably suit a modern economy better. Final-salary pensions tended to penalise early leavers and reward “time servers” who spend all their careers at a single firm. Instead, workers should be encouraged to be mobile, taking their pension rights with them every time they move. A study by Richard Hinz of America's Department of Labour found that, because of employment patterns, DB plans were actually more risky for employees than DC ones are.

But the Hinz study had one crucial assumption; that contributions to the two types of schemes are at the same level. They are not. Employers have taken advantage of the switch from DB to DC to cut the level of their payments drastically. That is hardly surprising: the cost of meeting the DB promise was what prompted employers to switch to DC schemes in the first place. Figures from Britain show that the average level of employers' payments into DB schemes, as of October 2007, was 14.2% of payrolls; in DC schemes, by contrast, the average was just 5.8%.

Employees are not making up the difference. They are pumping just 3% of their salaries into British DC schemes, taking the total to 8.8%, against the equivalent for DB schemes of 19.1%. In America total DC contributions at the last estimate were slightly higher than in Britain, but were still only 9.8%.

Lower contributions almost inevitably mean lower pensions. Watson Wyatt estimates that the median 25-year-old

contributing at the British DC rate would earn a pension of about 30% of his final salary. And that assumes an optimistic rate for annual costs of 0.3%, whereas many DC schemes have expense ratios of more than 1%. In DB schemes, contributing for 40 years would entitle the employee to 66% of final salary.



The loss to DC scheme members is partly offset by their own lower contributions—in other words, higher net pay—of around 2% a year. But DC members also have investment risk; for about 5% of them, the pension would be worth just 15% of their final salary.

You could argue that the comparison between DB and DC contributions is unfair, because DB payments have recently been inflated by the need for firms to spend money cutting the deficits that had built up in their pension funds. But the factors that caused those deficits—sluggish asset markets, lower bond yields and higher longevity—also face DC scheme members. If DB contributions are rising to cover the greater cost of meeting DB liabilities, then DC contributions should rise too.

But workers facing a loss from the switch to DC schemes have failed to pay in more, perhaps because they do not appreciate what a good deal pensions are. Andrew Warwick-Thompson, of Hewitt Associates, a benefits consultancy, says that focus groups of employees have shown that pensions rank a long way down the list of benefits they value. Flexible working or the chance of extra holidays are deemed much more important.

Another reason for employees' apathy may be the lack of spare cash, particularly if they are not paid much. There is also deferred gratification to overcome; until employees reach their 40s, retirement seems an awfully long way away. Spending cash straight away looks a lot more fun (see chart 2).

This is a shame, in pension terms, because of the miracle of compound interest. Invest $3,000 a year at age 55 (earning an annual return of 7%) and by age 65, you will have a pension fund of only $41,449. Start at age 45 and your fund will reach nearly $123,000, almost three times as much. But start at 25 and your pension fund will be worth almost $600,000.

In addition, fewer employees seem willing to take part in DC schemes. A survey by the Confederation of British Industry (CBI) in 2006 found that participation rates in the country were just 61%, compared with 90% for final-salary schemes. Given that employers still contribute to the vast majority of schemes (even if less generously than they did to DB schemes), workers are turning down free money. At 6% of pay, for instance, a British employer's contributions would add up to £300,000 over 40 years (assuming an average salary of £25,000 and an investment return of 7%). That is a decent-sized win on the lottery.

Slippers and cocoa

Is there a way around this shortfall? Take employees' reluctance to join a scheme. One answer is auto-enrolment. Studies find that inertia is a powerful force; employees would rather not fill in forms. If they have to apply to join a pension scheme, they may not bother. Auto-enrolment turns this inertia to the advantage of saving by asking employees to fill in a form if they want to opt out. This is the basis of the Australian pension system and will be introduced in Britain in 2012, as part of the new National Pensions Savings Scheme (NPSS). Britain's National Association of Pension Funds reckons auto-enrolment boosts scheme membership by 20-50%.

But not everyone admires the idea. Ros Altmann, an academic, argues that in places, such as Britain, where state benefits are means-tested, low-paid employees may find extra retirement saving is offset by a fall in their benefits when they retire. In addition, it is probably better for them to save in other ways rather than lock away their money in a pension that cannot be touched until their old age. They may suffer illness or unemployment, in which case they may want to be able to get their hands on the money. In theory, low-wage workers could be advised to opt out of the NPSS. But the scheme is understandably trying to keep its costs low so as to reduce the drag on members' returns. Such an approach will not make it possible to offer employees individual advice.

And low-paid employees may not be the only people who feel that pensions are not for them. When

graduates leave university, they are often burdened with student debt. Their priority is to pay it back. After that, they will probably want to save a deposit so they can buy a house. Either way, cash is a lot more useful to them than pension contributions are.

Rational or not, the lack of interest shown by employees hardly creates an incentive for employers to make pension schemes more attractive. “The HR director has to make a business case to the finance directors as to why they need a pension scheme,” says Mr Warwick-Thompson, “and the HR director has to show that the company is getting bang for its buck.”

The paradox of choice

Consumer choice, seemingly one of the advantages of DC schemes, is really another weakness. This emerged in its starkest form at Enron, an energy company where employees had chosen to invest more than half of their pensions' assets in the company's own shares. A DB plan, taking professional advice, would never have been exposed like that. Nor do employees appear to have learnt the lesson. A survey of 65 big American DC schemes, by *Pensions & Investments* magazine earlier this year, found that 26% of their assets were in the parent company's shares.

Academic studies suggest that employees are heavily influenced by recent market conditions. Figures show that American workers who began DC plans in 2000, at the height of the bull market, allocated 72% of their portfolio to the stockmarket; those who joined in 2003, after the long bear market, allocated just 48%. Once these decisions are made, inertia sets in; less than 10% of plan members in schemes run by Vanguard, a fund management group, change their asset allocation every year.

Studies also show that employees can be overwhelmed by the responsibility of making the investment selection. Rather than choose between a lot of funds, they decide not to choose at all. According to Barrie & Hibbert, a consultancy, the average take-up rate of schemes with just two investment options was 75%; for schemes with 40 options, the rate drops to 65%.

Just as important, more choice also means higher costs, and higher costs mean lower returns. Studies have shown that the average American DC scheme underperforms a DB scheme by around a percentage point a year. Calculations by Ennis Knupp and Associates, a Chicago-based consultancy, suggest that this alone can cut DC pensions by almost a fifth.

Some of these costs are caused by the administrative hassle of dealing with individual scheme members, who may have different contribution rates and asset allocations, rather than with a single DB fund. But it also reflects the ability of DC members to opt for higher-charging mutual funds. According to Ennis Knupp, DC members are far less likely to use low-cost index-tracking funds than DB plans are; that alone may result in higher costs of more than half a percentage point a year. According to Watson Wyatt, the average cost of running a pension fund has increased by 50% over the past five years.

One answer to the cost problem is to set up co-operative schemes that amalgamate the savings of workers in one industry, or even across industries. This is the basis of the Australian system, seen as an exemplar by commentators such as Keith Ambachtsheer of the Rotman International Centre for Pension Management in Toronto; TIAA-CREF, a pension fund for American academics, is also run on a co-op basis.

Company schemes can keep costs down by focusing on the default fund, the option that employees end up with (since they have difficulty making their own choice). Default funds can also be used to give employees a sensible asset allocation. In both the British and American markets, default funds tend to use a “lifestyle” or “target date” approach. This changes the asset allocation with the member's age. When members are young, they can take more risks, so there is a bigger exposure to equities; as they near retirement, they are shifted into government bonds, to protect their pension pot.

Illustration by Robin Chevalier

But Watson Wyatt argues that this approach is not sophisticated enough. Shifting employees entirely into bonds at age 65, when they may have 20 years to live, is not sensible. People have different attitudes to risk and will have savings outside the pension fund; their portfolios could be tailored to their needs. Instead of a single default fund, there could be several, with investors having various mixes, depending on the employee's situation. Employees may be willing to take more risk at a young age, adding further contributions to the plan

later if performance falls short of expectations. These more sophisticated plans may use alternative asset classes like hedge funds and private equity to control risk—although whether the benefits such managers bring outweigh their higher fees remains to be seen.

Better by design

The structure of these default funds is all-important because of the way employees make decisions. An academic study** offered three groups of employees a choice of two funds. One group was offered an equity and bond fund, a second group an equity and balanced fund, and the final group a bond fund and a balanced fund. The most common option was a 50/50 split between the two funds—but that led to the second group having an equity weighting in their portfolio of 73% and the third group a weighting of just 35%.

The trouble is that neither employers nor employees really know what DC plans are aiming to do. Over two-thirds of European plans surveyed by Mercer, a consultancy, had no formal objectives or goals.

In their Pensions Institute paper, David Blake, Andrew Cairns and Keith Dowd point out that DC plans are poorly designed. Instead of asking how much employees want to get out of the plan, the focus is on how much they are willing to contribute. "A well-designed plan will look very much like a defined-benefit plan, offering a promised retirement pension, but without the guarantees implicit in the DB promise," they argue. One way of achieving this would be for the default fund to target a pension level that is a proportion of final salary.

When it comes to pensions, the buck has been passed from employers to employees. But too few workers realise how much they need to contribute to guarantee a decent retirement or feel confident enough about how to invest their funds. This will not lead to the headlines about bankrupt pension funds that marked the decline of the DB scheme. But it will be bad for many workers all the same.

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* "Turning Pension Plans into Pension Planes: What Investment Strategy Designers of Defined Contribution Plans Can Learn from Commercial Aircraft Designers", www.pensions-institute.org

** "Naive Diversification in Defined Contribution Plans", by Shlomo Benartzi and Richard Thaler, 2001, http://faculty.chicagogsb.edu/richard.thaler/research/

Global markets

Too hot or too cold?

Jun 12th 2008
From The Economist print edition

Illustration by Satoshi Kambayashi

Investors are caught between the desire for growth and the fear of inflation

POOR Goldilocks is suddenly out of sorts. After five years when economic conditions have been, like baby bear's porridge, “just right”—strong growth and low inflation—they are now spoiling fast. And as central banks begin to react vigorously, investors are taking fright.

When 2008 started, most investors assumed that the lingering effects of the credit crunch would allow interest rates to fall, or at worst be kept on hold. But over the past week markets have priced in a number of rate rises later in the year from the Federal Reserve, the European Central Bank (ECB) and the Bank of England. That has caused turmoil in short-term government-bond markets (see chart), as yields have been forced sharply higher.

The problem is inflation. Central bankers may hope that soaring oil and food prices will prove to be just a blip, and will not result in secondary effects such as higher wages. But they know that higher inflation expectations, once entrenched, are difficult to eliminate. So they are sounding as tough as they can.

Tricky Trichet

This has not been well co-ordinated. On June 3rd Ben Bernanke, the chairman of the Fed, tried to talk up the dollar (a falling currency adds to inflationary pressures). But on June 5th Jean-Claude Trichet, the ECB president, gave a strong hint that euro-zone rates were soon to rise. That sent the euro sharply higher. As Albert Edwards, a strategist at Société Générale, put it: “Only [two days] after Bernanke made his dollar-supportive comments and retreated to the sidelines, he received the studmarks from Trichet's boot in his chest.”

If that central-banking snafu was not bad enough, June 6th saw both an unexpected rise in American unemployment and an $11 gain in the price of oil—a combination that points to higher inflation and slower growth. Small wonder that the Dow Jones Industrial Average tumbled nearly 400 points on the

day.

Investors fear that central banks, in their zeal to prove their anti-inflationary credentials, may inflict some severe damage on economic growth. The problems of the financial sector are far from over, as the $2.8 billion second-quarter loss at Lehman Brothers illustrated. Its share price continued to take a hammering this week as investors worried about its balance sheet and business model.

There have been few bond defaults as yet, but Stephen Dulake, a credit strategist at JPMorgan, reckons investors may be looking in the wrong place for trouble; there have already been 26 defaults in the American corporate-loan market this year. Credit spreads (the excess rates paid by risky borrowers), having fallen sharply between mid-March and mid-May, have been edging higher again.

Meanwhile, house prices are falling in America and Britain. Consumers are struggling to cope with the impact of that on their wealth and with the effect of higher fuel and food prices on their wallets; a rise in interest rates may push them over the edge. In the global economy, more bad news came on June 11th: Australian consumer confidence and New Zealand home sales fell to 16-year lows.

Nor is the task of balancing inflation and growth confined to the developed world. In China the central bank raised the amount of reserves banks must hold against their loans, in an effort to restrain inflation, and shares fell for seven days in a row up to June 12th. Inflationary fears led India's central bank to raise interest rates for the first time in more than a year.

In essence, the global economy has received two shocks in the past 12 months—the credit crunch and higher commodity prices. Those shocks have made the outlook more uncertain, not just for the economy but for monetary policy. And uncertainty makes investors nervous, not least because it comes after a long period when markets seem to have underpriced risk. “Recent years have seen the world get all the benefits of globalisation without the costs,” says Peter Oppenheimer, a strategist at Goldman Sachs. “Emerging markets got growth, developed countries kept the lid on inflation.”

But higher commodity prices are a zero-sum game; for every winner, there is a loser. Many of those losers are likely to be companies. Profit margins have been at historic highs in some big countries, in large part because businesses have been successful in controlling labour costs. But higher raw-material prices present firms with a problem. Pass those costs on, and not only will consumer demand falter, but central banks may raise rates. So they may have to accept lower margins instead.

At the start of the year analysts were forecasting 15% profits growth for European companies in 2008. Revisions have brought that number down to 4%, largely because of problems in the finance industry. But Goldman Sachs thinks analysts are still too optimistic; it is predicting an earnings decline of 12% this year. A combination of higher interest rates and lower profits makes it difficult to see how stockmarkets could advance much during the rest of the year.

Currency markets are also likely to be volatile. The Fed would like to engineer a rise in the dollar against the euro and the yen and a fall against the developing Asian currencies. But that will be hard to pull off as central banks around the world grapple with the inflation/growth trade-off. The dollar's yield will continue to look unattractive, since American interest rates are likely to remain lower than most (bar Japan's). The Bank of Canada, which was widely expected to cut rates this week, decided to keep them steady.

And government-bond markets may also be set for turmoil. Analysts have been scratching their heads at some of the recent moves. “If we told you that the Dow fell by 400 points one Friday after the largest rise in the unemployment rate in nearly three decades, would you buy or sell two-year Treasury notes?” asks William O'Donnell, a strategist at UBS. The usual response would be to buy, but investors sold. Expectations of higher short-term interest rates trumped the safe-haven appeal of the bonds.

At the ten-year level, it may seem odd that investors are willing to receive a Treasury-bond yield of just 4.1% when headline inflation is 3.9%. But if the American economy slips into recession, ten-year yields could fall a lot lower than that; they were 3.1% in June 2003.

So, a world without Goldilocks would be a harsh one for investors. It is not a place where bears eat porridge and go for strolls in the wood. It is one where bears eat ingénues for breakfast.

Buttonwood

Let them heat coke

Jun 12th 2008
From The Economist print edition

How green taxes hurt the poor

Illustration by Satoshi Kambayashi

AS SPANISH hauliers and French fishermen have shouted out for all the world to hear, higher fuel prices are not popular. This is uncomfortable for those—including this newspaper—who see increased taxation as a way of fighting global warming. Green taxes tend to fall hardest on the poor.

You could see the rise in the oil price over the past five years as a gigantic carbon tax. It is, at last, succeeding in cutting demand in the developed world (although not yet in the developing one). But it has been extremely painful for some parts of society.

There may be worse to come. Many climate experts favour the ambitious target of cutting carbon emissions by 80% before 2050. Technological change will help. But encouraging those new technologies may well call for higher energy taxes.

In America the Congressional Budget Office has estimated that a cap-and-trade system, designed to cut emissions by 15%, would reduce the average income of the lowest quintile of the population by 3.3% and the richest quintile by just 1.7%.

The effect on the poor is not uniform; fewer drive cars, for example. But those that do spend a big part of their income on petrol. In 2007 Britain's Institute for Fiscal Studies (IFS) estimated that a 5% rise in fuel duty would cut the income of the poorest decile of Britons by 0.27%; the richest decile would lose only 0.11%.

And although the poor may not all drive, they must all heat their houses in winter. According to an IFS paper* last year by Don Fullerton, Andrew Leicester and Stephen Smith, the poorest decile of British households spent 12% of their income on fuel in 2004, compared with just 4% for the richest decile. (It is a safe bet that the share has since risen.) In addition, the wealthy have more money to spend on products that improve energy efficiency, such as insulation and hybrid cars.

The link between fuel and food prices only worsens the burden on the poor. This has caught people's attention because corn is being used as a biofuel. But oil is also a constituent of many fertilisers and the growth of emerging markets is affecting demand for both. Once again, the poor devote more of their budget to food than the wealthy do.

The answer might seem simple. Let the green taxes rip and then compensate low earners by making more benefits available to them. A similar answer has been proposed for the adverse affects of globalisation; rather than restricting trade, governments should instead seek to cushion globalisation's impact on those members of the population that lose.

A report** by the Joseph Rowntree Foundation in 2004 suggested several ways to do this, for example by using a lower energy tariff for those on benefits or granting a free water allowance to some households. But the report came up against one difficulty. You could devise compensation packages that made the average poorer person better off. But widely differing uses of energy meant that around 20% of the poorest households would still lose out. In a way, governments would be faced with a similar problem to the one that bedevilled Gordon Brown, the British prime minister, earlier this year when he sought to abolish the country's lowest rate of income tax. The change produced some losers, and their grievance counted for more than the gratitude of the numerous winners.

There would be other drawbacks with a tax-and-compensate system. If such an approach were means-tested, the effect would be to increase marginal tax rates for the poor (since benefits will be withdrawn as incomes rise). That will reduce incentives to work.

Even if the benefits are not means-tested, they may counteract the effect of higher taxes on energy demand. In Britain, for example, all pensioners are given a winter-fuel allowance. But it seems odd to try to prevent energy use with higher taxes on the one hand and then to subsidise it on the other.

The fundamental problem is difficult to get round. If governments desire people to use less energy, they have to ration supply by price. They can limit frivolous use (gas-guzzling cars, televisions on standby and the like). But there may be a core demand for energy (heat, light, commuting) where consumers will resist cuts. For that part, the rich will always be able to outbid the poor (not to mention the politically powerful middle class). And that will plague green campaigners.

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* "Environmental taxes" by Don Fullerton, Andrew Leicester and Stephen Smith. Institute for Fiscal Studies, March 2007

** "Green taxes and charges: Reducing their impact on low-income households" by Paul Ekins and Simon Dresner. Joseph Rowntree Foundation, October 2004

Economist.com FINANCE & ECONOMICS

Money-market funds

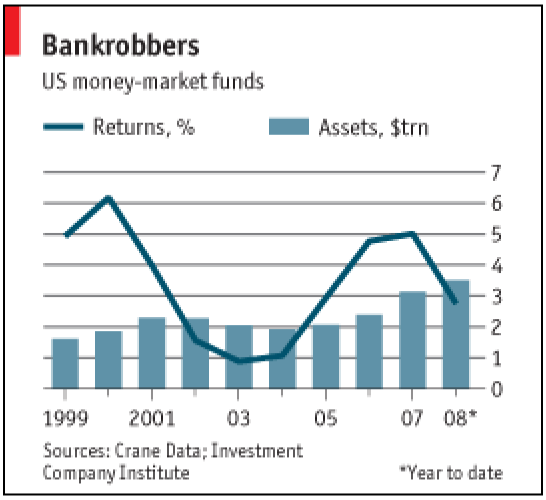
A boom amid the bust

Jun 12th 2008 | NEW YORK
From The Economist print edition

Can the success of money funds last?

THE credit crisis has produced many losers and a few winners. Among money-market mutual funds, which invest in short-term debt and other instruments, it is the other way round. Some funds that exposed themselves to mortgage-linked exotica, albeit indirectly, have had to be bailed out by their managers. But many of the rest have done nicely as worried investors flocked to them, seeking safety.

Long an unexciting province within asset management, money funds have played a big role in the crunch. They bought much of the short-term debt that propped up structured finance. It was their sudden withdrawal that caused the market in asset-backed commercial paper (ABCP) to seize up. And banks' liquidity problems are largely the result of money funds' recent reluctance to hold their debt.



If this makes them villains, then crime pays. Money funds have been taking market share from banks for years: big banks were less interested in competing for deposits during the securitisation boom, since they were selling on their loans. The crisis only accelerated this shift, since money funds were seen as one of few havens. In America, the biggest market, their assets have increased by 39% over the past year, to a record $3.5 trillion, even as returns have fallen (see chart).

This growth has been fuelled primarily by institutional money: businesses, pension funds and local governments. By the end of 2007, money funds held a record 31% of corporate America's short-term assets, a share that is thought to have continued rising this year.

Why are companies flocking to outsource their cash management? In the boom, all that mattered to them was yield, and they did not need help finding it. Now they crave liquidity and sanctity of principal—a welcome rediscovery that short-term holdings should “bore you into a good night's sleep”, as Reserve Management's Bruce Bent, creator of the first money fund in 1970, puts it. Money funds, with robust credit departments that do not simply rely on ratings, are better placed than corporate treasurers to provide this.

There is also some back-covering at work. After over-exposing themselves to structured-investment vehicles and auction-rate securities, treasurers want to be able to blame someone else if things go wrong again. Moreover, money funds offer some built-in protection. In this crisis, as in past ones, they have shown they will do all they can to avoid “breaking the buck” (allowing their net asset value to fall below par). More than a dozen managers have stepped in to shore up funds, at a cost of more than $1 billion.

Money funds have also benefited from a withering of the competition. Ultra-short bond funds and enhanced-cash funds, which touted themselves as cash alternatives but invested in spicier debt than true money funds are allowed to, have fallen by the wayside. Peter Crane of *Money Fund Intelligence*, a newsletter, puts their combined assets at $70 billion, down from over $600 billion before the crisis. Meanwhile, the market for auction-rate securities is a shadow of what it was.

In some ways, money funds created a virtuous circle for themselves. As they fled structured vehicles and the like, others who had gobbled up such debt also took fright—and stuffed their money in funds instead. An unusually large share went to government debt: JPMorgan Chase's Treasury-bill fund swelled from $7 billion to $37 billion, for instance. It has lost some of that to “prime” money funds, which buy corporate debt, over the past month as investors regained some appetite for risk. But funds remain choosy about

which banks they will finance. The same goes for the ABCP market, which remains one-third below its size last August.

Will money funds be able to hold on to the huge inflows? Mr Crane expects America's to continue registering double-digit annual asset growth. On the other hand, the funds tend to suffer when short-term interest rates rise, or when turmoil subsides. In a recent report, Jan Loeys, an economist at JPMorgan, predicted a bleak future for the funds in which the banks that have become so dependent on them fight back. As the lend-and-hold model of banking regains ground, he argues, so banks' interest in cutting out those interposed between them and their retail customers will grow. Already they are jostling for deposits with new-found vigour.

Economist.com FINANCE & ECONOMICS

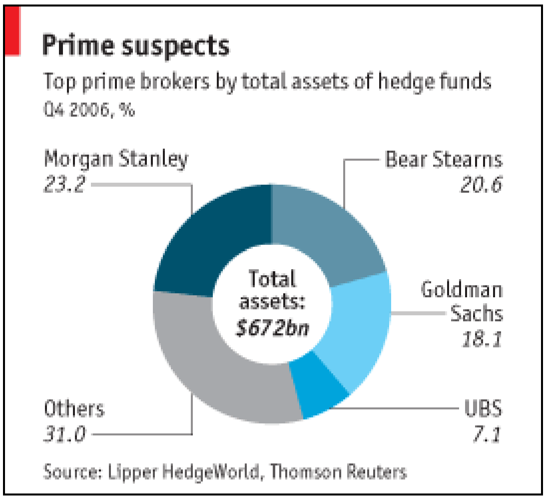
Hedge funds

The counterparty's over

Jun 12th 2008
From The Economist print edition

Brokers may now be a bigger risk

IT USED to be hedge funds that endangered the existence of banks. In September 1998 Bear Stearns threatened to stop trading with its reckless client Long-Term Capital Management (LTCM). Thirteen days later the Federal Reserve Bank of New York orchestrated a bail-out of LTCM, believing it posed a threat to the financial system. This year the direction of counterparty risk has reversed. Some hedge funds worry they could be dragged down if a bank goes under. After all, Bear Stearns was the industry's second-biggest prime broker (see chart), providing hedge funds with a myriad of services including lending and the custody of assets. As Bear approached bankruptcy, these clients rushed to move their accounts to other banks. Customer balances shrank by one-quarter in the month before JPMorgan Chase came to the rescue.



Hedge funds' concern reflects their symbiotic relationship with prime brokers (investment banks sometimes even provide office furniture to budding George Soroses). If a bank's capital becomes scarce and it needs to tighten its lending terms, it can end up hurting a highly leveraged fund. If a bank goes bust, the effect on its prime-brokerage clients could be fatal. Hedge funds typically park their assets at their prime brokers, which may in turn lend them on to other firms. Retrieving those assets quickly may be tricky if the bank enters receivership. Furthermore, many hedge funds own over-the-counter derivatives written by their prime brokers. How funds would crystallise the notional profits on those contracts if their counterparty went bankrupt is one of finance's great unknowns.

On June 9th the New York Fed and a group of banks and investors embraced reform by agreeing to develop a central counterparty, or clearing house, for credit-default swaps, a hugely popular type of derivative. For hedge funds, trying to protect assets held at prime brokers may be harder. Employing several brokers can diversify a fund's exposure, but since a few investment banks dominate the business, this shuffles overall risk around rather than lowering it. Most types of hedging would not achieve much, since they in turn rely on other counterparties. As a result, says Rick Sopher, the chairman of LCH Investments, a fund of funds, some hedge funds have been poring over their prime-brokerage agreements, seeking ways to ring-fence their accounts and to park spare cash in safer banks.

Even if contracts are rewritten, banks and hedge funds are so intertwined that counterparty risk is a fact of life. Fortunately, since Bear's rescue, a superior form of insurance now exists: an implicit guarantee of big investment banks by the Fed. Even Lehman Brothers, where the balance sheet is under especially close scrutiny, said on June 9th that its prime-brokerage business was doing well. Robert Sloan of S3 Partners, a hedge-fund adviser, thinks the danger now is that the Fed tightens investment-bank regulation in return for its backing. The prime brokers' habit of making cheap loans to hedge funds in return for poor collateral may well be over.

International banks

Overstretched and over there

Jun 12th 2008
From The Economist print edition

The credit crunch causes emerging markets to take stock

ALL successful relationships depend on mutual attraction. For international banks, emerging markets have long been alluring; now that Western economies are stuttering, they look irresistible. Foreign-bank loans to borrowers in developing countries soared from $1.1 trillion in 2002 to $4 trillion at the end of 2007. In addition, the banks can provide expertise. But the credit crunch has given emerging markets reasons to reconsider the relationship.

One reason is cyclical. According to the World Bank, tighter conditions in interbank markets have a big effect on flows of bank credit to emerging markets. The bank's latest *Global Development Finance* report predicts that an increase of ten basis points in the gap between the London Interbank-Offered Rate (LIBOR) and the overnight indexed-swap (OIS) rate, sustained over a quarter, should cause net lending to developing countries to drop by up to 3%. In reality, LIBOR-OIS spreads have spiked longer and higher than that. A pullback is not visible yet but if it comes, Mansoor Dailami, the report's lead author, says that local banks would find it hard to plug gaps left by foreigners in capital-intensive areas such as infrastructure projects.

Other concerns are more structural. One is the extent to which increasing levels of foreign-bank ownership weaken the effectiveness of domestic monetary policy. The report suggests that the sensitivity of bank-lending rates to central-bank rates in a country goes down as the proportion of foreign-owned banks goes up—since banks can borrow internationally. That is bad news for regulators who are trying to prick an asset bubble. It could be even worse when boom turns to bust: it is horribly unclear how governments would react if a large foreign-owned bank got into real trouble.

These questions resonate more in some places than others. Foreign banks are particularly active in central and eastern Europe. Raiffeisen, an Austrian bank, accounted for almost half of Albania's banking assets in 2006, SEB of Sweden for one-third of Lithuania's. In 1995 foreign banks controlled $41 billion of assets in the ten countries that joined the European Union in 2004; in 2006, they had assets worth $528 billion. East Asia has been much less welcoming.

Such stand-offishness carries a high price. Foreign banks spur competition, introduce new products and increase access to credit. Shabby though many foreign suitors seem at the moment, emerging markets should not be too quick to reconsider their vows.

Bank liquidity

Litterbin of last resort

Jun 12th 2008 | FRANKFURT
From The Economist print edition

The assets being dumped on the ECB do not look very recyclable

AFP

OH DEAR, it was not meant to be like this. The European Central Bank (ECB), widely praised for providing banks with ample liquidity during the credit crunch, now has a problem: how to encourage banks to place freshly created asset-backed securities (ABS) with investors, rather than dumping them, like so much radioactive waste, in its vaults.

The ECB accepts a wide range of assets, including those such as ABS for which there is temporarily very little trading, as collateral in its refinancing operations. Provided the tranche of securities is the most senior, and rated A- or above, the ECB will take it. No surprise then that since August a large number of banks have designed ABS tranches, backed mostly by mortgages, purely for ECB consumption. Of €208 billion ($320 billion) of eligible securities created, only about €5.8 billion have been placed with investors, according to calculations by JPMorgan. In one noteworthy deal in December, Rabobank, a Dutch institution, issued €30 billion of mortgage-backed securities, €27 billion of which were designed exclusively for refinancings with the ECB.

On the face of it there is no immediate problem. Only around 16% of the ECB's collateral so far is ABS. Banks are drinking from the liquidity fountain and keeping the cost of high-street mortgages contained at the same time, which they might not be able to do otherwise.

But it is not helping the revival of a publicly traded ABS market, and may be fostering the creation of even murkier securities. Many of today's ABS are even less transparent than those sold before the crisis—the ECB requires a rating by only one agency, not the usual two, and pre-sale reports are often sloppily prepared. That, at least, is the concern of some rival central bankers, although the ECB itself is not panicking, yet. José Manuel González-Páramo, an ECB director, urged bankers earlier this month to make “serious efforts to revive the interest of third-party investors”. Though action is needed, the bank will not do anything in a rush—the markets are still too fragile for that.

All the main central banks have learnt a lot from this crisis. America's Federal Reserve and the Bank of England found that they had too few tools to cope with the liquidity drought. The Fed threw open its emergency lending facilities to investment banks, as well as accepting a much broader range of collateral in its open-market operations. The Bank of England, several months too late, widened the range of collateral it accepts as well. Only the ECB, rather smugly, can say that it has stuck to its pre-crisis rules. But there are still gaping differences that can be “gamed”, or arbitraged, between the three systems.

The Fed accepts complex credit derivatives in its liquidity operations, which the others do not; the Bank of England, with its Special Liquidity Scheme dating from April, accepts AAA securities of all types, but only those held on a bank's balance sheet before the end of last year. The British bank also applies more stringent “haircuts”—ie, it is tougher on valuations—than the ECB, according to market participants. The result, unless the ECB changes its tune, is that it could well end up as the repository of last resort. If banks start to default, the ECB—and ultimately the euro-zone taxpayer—could be left holding a lot of toxic assets. Almost as bad—for those with a mind for justice—is the thought that the same supposed rocket scientists, using the same benighted techniques that caused the mess, may be taking everyone for a ride again.

Central bank liquidity policy needs refining and harmonising, as the Financial Stability Forum, a group of banking-industry regulators, made clear in a report in April. This week Mervyn King, the Bank of England's governor, hinted at plans for an integrated framework “making clear the terms on which

liquidity will be provided in times of stress”.

Market participants say the trouble is that spelling out those terms beforehand can create moral hazard and encourage recklessness. One argument doing the rounds is that the ECB's broad acceptance of collateral before the crisis may actually have added fuel to the fire.

International taxation

America's Berlin Wall

Jun 12th 2008 | HONG KONG
From The Economist print edition

Congress increases the ransom expats must pay to escape the taxman

QUEUES of frustrated foreigners crowd many an American consulate around the world hoping to get into the United States. Less noticed are the heavily taxed American expatriates wanting to get out—by renouncing their citizenship.

In Hong Kong just now, they cannot. “Please note that this office cannot accept renunciation applications at this time,” the consulate's website states. Apart from sounding like East Germany before the fall of the Berlin Wall, the closure is unfortunately timed. Because of pending legislation on President Bush's desk that is expected to become law by June 16th, any American who wants to surrender his passport has only a few days to do so before facing an enormous penalty.

That penalty is buried in an innocuous piece of legislation with the veto-proof name, Heroes Earnings Assistance and Relief Tax (HEART) act. The new law means active American soldiers will benefit from tax relief. To pay for that, Congress has turned on expats, especially those who, since new tax laws in 2006, have become increasingly eager to give up their citizenship to escape the taxman.

Under the proposed legislation, expatriates surrendering their citizenship with a net worth of $2m or more, or a high income, will have to act as if they have sold all their worldwide assets at a fair market price. If the unrealised gains on these assets exceed $600,000, capital-gains tax will apply. A study by the Congressional Budget Office guesses that the new law will progressively net the government up to $286m over five years. It is unclear, however, why people would suffer the consequences if they did not expect to save money in the long run by escaping American taxes.

That expats want to leave at all is evidence of America's odd tax system. Along with citizens of North Korea and a few other countries, Americans are taxed based on their citizenship, rather than where they live. So they usually pay twice—to their host country and the Internal Revenue Service. As this makes citizenship less palatable, Congress has erected large barriers to stop them jumping ship. In 1996 it forced people who renounced citizenship to continue paying income taxes for an extra ten years. Theoretically, the new law allows for a cleaner break.

But even as the law tries to prevent people from renouncing their citizenship, it may have the opposite effect. Under the new structure, it would make financial sense for any young American working overseas with a promising career to renounce his citizenship as early as possible, before his assets accumulate. For everyone else, plunging stock and property prices mean now may be as good a time as any to hand back the passport, says Kurt Rademacher, a partner at Withers, a global tax-planning firm.

In Hong Kong the temptation for Americans to switch citizenship is particularly strong, because of the territory's low taxes. On the other hand, banks and other firms who want to hire Americans may find it harder to do so, even though greater China is one of the world's fastest-growing regions. It places Americans in the awkward position of weighing their patriotism against their vocation.

Economics focus

Control freaks

Jun 12th 2008
From The Economist print edition

Are “randomised evaluations” a better way of doing aid and development policy?

Illustration by Jac Depczyk

DOCTORS study diseases from several vantage points. Laboratory scientists peer into microscopes to observe the behaviour of bugs. Epidemiologists track sickness in populations. Drug-company researchers run clinical trials. Economists have traditionally had a smaller toolkit. When studying growth, they put individual countries under the microscope or conduct cross-country macroeconomic studies (a bit like epidemiology). But they had nothing like drug trials. Economic data were based on observation and modelling, not controlled experiment.

That is changing. A tribe of economists, most from Harvard University and the Massachusetts Institute of Technology (MIT), have begun to champion the latest thing in development economics: “randomised evaluations” in which different policies—to boost school attendance, say—are tested by randomly assigning them to different groups. In one celebrated example, researchers looked at what happened in 20 antenatal clinics in western Kenya when some gave away insecticide-treated bednets, an anti-malaria therapy, and others sold them for different prices. Their conclusion was that free distribution is far more effective in getting people to use bednets than charging even a nominal sum would be.

Such trials are not unprecedented in economics. America's welfare reform of 1996 was based partly on controlled experiments. But they have been rare enough for today's upsurge to count as a revolution in thinking about development. Last year the Spanish government gave the World Bank €10m ($16m)—the institution's largest trust fund—to spend on evaluating projects. The fund's first criterion calls for randomised trials. This will spread their influence further.

But are such trials all they are cracked up to be? *Randomistas* recently gathered at the Brookings Institution, a think-tank in Washington, DC, to discuss that.*

Randomised evaluations are a good way to answer microeconomic questions such as how to get girls to go to school, and teachers to turn up for work. They cannot tell you much about macro questions like the right exchange-rate or budget policy. But often, they provide information that could be got in no other way. To take bednets: supporters of distributing free benefits say that only this approach can spread the use of nets quickly enough to eradicate malaria. Supporters of charging retort that cost-sharing is necessary to establish a reliable system of supply and because people value what they pay for. Both ideas sound plausible and there was no way of telling in advance who was right. But the trial clearly showed how people behave.

So evidence from randomised trials is good. But is it better than other economic data? That is what many *randomistas* believe. Abhijit Banerjee, the co-founder of the Abdul Latif Jameel Poverty Action Laboratory (J-PAL), argues that “the quality of the evidence that informs much of the macro-growth debates is significantly worse than the quality of the data that bears on many of the micro-policy questions”. He adds: “The beauty of randomised evaluations is that the results are what they are.” In other words, they provide hard evidence, resting on a solid empirical base. Aid and development policy, concludes Mr Banerjee, should take more account of that evidence.

But is the evidence really incontrovertible? On its own terms, yes. As Mr Banerjee says, the evidence is what it is. But policymakers do not want to know whether something works in a few villages. They want to know whether it will work nationwide. Here, randomised trials may not be quite so helpful.

Go back to the bednets once more. You might conclude that the trial showed that they should always be given away. Yet it turns out that millions of nets were already in use in the part of Kenya where the field trial took place, so their value was known. The experiment guaranteed supplies, so it did not test the assertion that you need to charge something to encourage reliable suppliers. And the recipients were pregnant women, whereas the point of giving bednets away is to provide anti-malaria treatment universally. The evidence from western Kenya was clear. But it hardly settled the question of whether the government should give bednets away across the country. Questions like that may still have to be made on the basis of the soft evidence that *randomistas* turn up their noses at.

Randomistas rule?

Mr Banerjee doubts whether *randomistas* and other development economists will ever get along. The differences over research methods and what counts as evidence are too great. Economists do not know enough about growth, he says, to justify their obsession with it, however important it may be. Following the law of comparative advantage, they should do much more of what can be done best—randomised testing.

But given doubts about how widely applicable such tests are, it may be better to think of them not as a new, superior form of development economics but as one more technique—admittedly a useful one—for finding out what works, filling in gaps in knowledge, testing policy ideas, and puncturing conventional wisdom. Dani Rodrik of Harvard University argues that differences in research methods between *randomistas* and other economists are in danger of re-opening a split between macro- and micro-economists that is starting to heal. Over the past few years, he claims, both groups have converged on a more experimental approach to development, eschewing lists of standard prescriptions and stressing the importance of context. That approach may be bearing fruit. It would be a shame if triumphalist claims by *randomistas* were to limit their contribution to it.

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*Papers available at: www.brookings.edu/events/2008/0529_global_development.aspx

Consumer fuel cells

In search of forever

Jun 12th 2008
From The Economist print edition

Illustration by Stephen Jeffrey

As a source of power for cars, fuel cells have been a disappointment. For laptops and mobile phones, they are just about to take off

METHANOL is nasty stuff. Careless distillation in many a backwoods still has caused it to blind the imbibers of “alternative” alcoholic drinks. Yet it has its uses, and one of them may be to restore fuel cells to their oft-vaunted role as the power packs of the future—but with a twist. The main role that has been discussed for fuel cells over the past few decades is as replacements for the internal-combustion engine. Their actual use may turn out to be to provide power for portable electronic devices.

A fuel cell is a device that combines hydrogen with oxygen to generate electricity. The traditional approach has been to use the gas itself in the cell—and that is the approach taken by the world's carmakers in their so-far not very successful attempts to make a commercial fuel-cell-driven car. Since gaseous hydrogen is hard to store and handle, an alternative that some people have considered is to lock the hydrogen up in methanol, a liquid whose molecules are made of a carbon atom, an oxygen atom and four hydrogen atoms. Methanol will react with water in the form of steam to make hydrogen and carbon dioxide—a process known as steam reformation. Put a steam reformer in a car along with the fuel cell and you can fill the tank with methanol instead of hydrogen.

That idea has not gone very far, either. But it has provoked another thought. What if it were possible to decompose the methanol without steam, and within the fuel cell itself? And that has, indeed, turned out to be possible. The resulting cells are nowhere near powerful enough to run cars, but they are plenty powerful enough to stand in for small batteries. What is more, they last far longer than batteries and when they do need recharging, it is the work of a moment.

Proton power

In a direct-methanol fuel cell (DMFC) the methanol is oxidised at the anode in the presence of liquid water. The reaction, which requires a catalyst, turns the methanol and water into protons and electrons (in other words, dissociated hydrogen atoms) and carbon dioxide. While the electrons pass along an external circuit as an electric current, the protons diffuse through a membrane to the cathode, where they recombine with the incoming electrons to form hydrogen atoms that react instantly with oxygen to

make water. With pleasing symmetry the water is then channelled back to mix with the incoming methanol. Even though DMFCs produce carbon dioxide, the amount is small enough for the cells to count as a much greener technology than batteries. Some companies also think the new cells could be safer than batteries, which can burst into flame if short-circuited.

The efficiency of a DMFC is determined by its membrane. One of the most commonly used sorts is made of Nafion, a polymer developed by DuPont from a variation of Teflon. Nafion, however, can be expensive and it allows some methanol to seep through, which wastes fuel. Researchers are therefore trying to come up with more efficient membranes—and one group, led by Paula Hammond of the Massachusetts Institute of Technology (MIT), appears to have done so.

Dr Hammond and her colleagues used a newish thin-film fabrication technique known as “layer-by-layer”. This repeatedly dips a material into a solution, to build it up one layer at a time, while the properties of the liquid are gradually changed. That enables the structure of the resulting film to be fine tuned. When Dr Hammond coated a Nafion membrane in this way it became less permeable to methanol but kept its ability to transport protons. The effect, which the group reported in a recent issue of *Advanced Materials*, was to boost the cell's electrical output by more than 50%. The next stage, which the team has now embarked on, is to build complete membranes rather than mere coatings. The researchers think these may be able to work as proton-exchange membranes in their own right.

Squeeze me, please me

Toshiba, a large Japanese electronics firm, reckons that DMFCs can be used to produce mobile devices that have no need for batteries at all. In its latest investment plan, it says it will begin making such cells within a year for mobile phones and laptops. Sharp, one of its rivals, recently said that it had developed new microfabrication techniques to build DMFCs with the highest power densities yet achieved. Sharp reckons this will enable it to produce cells that are the same size as the lithium-ion batteries used in mobile devices, but which can run those devices for much longer. Some in the industry talk of mobile phones capable of operating continuously for several weeks before their fuel cells need topping up.

The most likely way that topping up will be done is with a cartridge of methanol that is inserted into the device and replaced when it is running low. As portable devices become more sophisticated, with added functions and large colour screens, they are draining batteries faster. MTI Micro, an American company, has put its version of a DMFC into satellite-navigation devices, which are often used for long periods. The company says it can run even a power-hungry model for up to 60 hours before the gadget needs refuelling.

Longer life is a big appeal; some people would like to run their laptops continuously on a 12-hour flight. Hence, new rules are being drawn up for aircraft. America's Department of Transportation is planning a rule change from October 1st to allow passengers and crew to bring fuel-cell-powered electronic devices and one or two fuel cartridges on board in their carry-on baggage. To qualify, the devices will have to meet certain safety standards. It is proposed that each passenger would be limited to about 200ml of fuel.

Successful work like that at MIT will help to make DMFCs cheaper and more efficient, which will, in turn, make them even more attractive as power sources for portable devices. Already, some companies are predicting that sales of refuelling cartridges could run into the billions within a few years of them coming into the market. Forget, then, the familiar cry: “Has anyone got a charger I can borrow?” It will be replaced by: “Can you spare me a squirt of methanol?”—and that won't mean in your hooch.

Evolution and genetics

The misfits

Jun 12th 2008
From The Economist print edition

The genetic legacy of nomadism may be an inability to settle

ABOUT one in 20 children (those under 18) have a group of symptoms that has come to be known as attention-deficit hyperactivity disorder (ADHD). About 60% of them carry those symptoms into adulthood. For what is, at root, a genetic phenomenon, that is a lot—yet many studies have shown that ADHD is indeed genetic and not, as was once suspected, the result of poor parenting. It is associated with particular variants of receptor molecules for neurotransmitters in the brain. A neurotransmitter is a chemical that carries messages between nerve cells and, in the case of ADHD, that chemical is often dopamine, which controls feelings of reward and pleasure. The suggestion is that people with ADHD are receiving positive neurological feedback for inappropriate behaviour. The surprise is that the variant receptors are still there. Natural selection might have been expected to purge them from the population unless they have some compensating benefit.

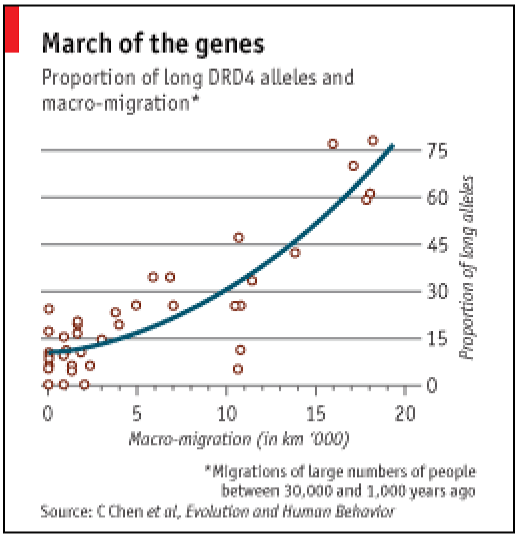
Of course, this analysis turns on the definition of “inappropriate”. The main symptom of ADHD is impulsiveness. Sufferers have trouble concentrating on any task unless they receive constant feedback, stimulation and reward. They thus tend to flit from activity to activity. Adults with ADHD tend to perform poorly in modern society and are prone to addictive and compulsive behaviour. But might such people do well in different circumstances?

One hypothesis is that the behaviour associated with ADHD helps people, such as hunter-gatherers and pastoral nomads, who lead a peripatetic life. Since today's sedentary city dwellers are recently descended from such people, natural selection may not have had time to purge the genes that cause it.

Dan Eisenberg, of Northwestern University in Illinois, and his colleagues decided to test this by studying the Ariaal, a group of pastoral nomads who live in Kenya. The receptor Mr Eisenberg looked at was the 7R variant of a protein called DRD4. Previous work has shown that this variant is associated with novelty-seeking, food- and drug-cravings, and ADHD.

The team looked for 7R in two groups of Ariaal. One was still pastoral and nomadic. The other had recently settled down. As they report in this week's *BMC Evolutionary Biology*, they found that about a fifth of the population of both groups had the 7R version of DRD4. However, the consequences of this were very different. Among the nomads, who wander around northern Kenya herding cattle, camels, sheep and goats, those with 7R were better nourished than those without. The opposite was true of their settled relations: those with 7R were worse nourished than those without it.

How 7R causes this is not yet known. It may stem from behavioural differences or it may be that different versions of DRD4 have different effects on the way the body processes food. Nevertheless, this discovery fits past findings that 7R and a set of similar variants of DRD4, known collectively as “long alleles”, are more common in migratory populations.



One suggestion is that long-distance migration selects for long alleles (see chart) because they reward exploratory behaviour. This might be an advantage in migratory societies because it encourages people to hunt down resources when they constantly move through unfamiliar surroundings.

As for the Ariaal, there remains the question of why 7R—although it is apparently beneficial to a nomadic way of life—is found in only a fifth of the population. One possibility is that its effects are beneficial only when they are not universal, and some sort of

equilibrium between variants emerges. A second is that the advantage is gained when 7R exists along with another version of DRD4 (the genes for the two variants having come from different parents). Unfortunately, the way Mr Eisenberg collected the data does not allow these hypotheses to be tested.

Either way, his research raises the question of whether people suffering from ADHD and conditions related to it, such as addiction, are misfits coping with a genetic legacy that was useful in the evolutionary past, but is now damaging. As society continues to diverge from that evolutionary past, the economic and social consequences of being such a misfit may become increasingly important.

Genetic archaeology

Mammoths

Jun 12th 2008
From The Economist print edition

Stephan Schuster lab, Penn State

This is not any old hairball. It is a very old hairball. It comes from a woolly mammoth that was buried in the Siberian permafrost. An analysis of its DNA, and the DNA from 17 other mammoths, by Stephan Schuster, of Pennsylvania State University and published in the *Proceedings of the National Academy of Sciences*, suggests the species was composed of two genetically distinct groups. One of these groups became extinct 45,000 years ago, well before people arrived in the area mammoths inhabited. That re-opens the question of whether it was people or climate change that finally did the species in.

Swimsuit technology

Making no waves

Jun 12th 2008
From The Economist print edition

A new swimsuit is shattering records and unleashing debate

ATHLETES in the ancient Olympics competed in the buff, on the grounds (among other things) that clothes were a hindrance to performance. Modern technology, however, has changed that. In some sports, notably swimming, the right attire can be an enormous boon. Take Speedo's LZR swimsuit, which was introduced in February. Fully 38 of the 42 world swimming records that have been broken since then have fallen to swimmers wearing LZRs. Indeed, some of those records have been claimed by less-than-notable racers, suggesting that the difference lies in the apparel, not the athlete.

To make the LZR, four innovations had to come together. The first is the fabric. The new suit is cut from a densely woven nylon-elastane material that compresses the wearer's body into a hydrodynamic shape but is extremely light. Moreover, there are no sewn seams. Instead, the suit is bonded by ultrasonic welding. Seams act as speed bumps in the water. Ultrasonic welding removes 6% of the drag that would otherwise occur, according to Jason Rance, the head of Aqualab, Speedo's research and development centre in Nottingham, Britain. Compared with Speedo's previous suit, which was used by numerous gold medallists in the 2004 Olympic games, the new material has half the weight yet triple the power to compress the body.

Second, the suit has what Speedo calls an “internal core stabiliser”—like a corset that holds the swimmer's form. As a swimmer tires, his hips hang lower in the water, creating drag. By compressing his torso, the LZR not only lets him go faster, because it maintains a tubular shape, but also allows him to swim longer with less effort. In tests, swimmers wearing the LZR consumed 5% less oxygen for a given level of performance than those wearing normal swimsuits did.

The third innovation, a further drag-reduction measure, is that polyurethane panels have been placed in spots on the suit. This reduces drag by another 24% compared with the previous Speedo model. Fourth, the LZR was designed using a three-dimensional pattern rather than a two-dimensional one. It thus hugs a swimmer's body like a second skin; indeed, when it is not being worn, it does not lie flat but has a shape to it.

The results are a suit that costs $600 and takes 20 minutes to squeeze into, and a widespread belief among swimmers competing in the Beijing Olympics this summer that they will have to wear one or fail. The director of the American team, Mark Schubert, for example, thinks the LZR improves performance by as much as 2%—a huge leap considering that tenths of a second may mark the difference between first and fourth place. Arena, a rival swimsuit maker, called the situation “unprecedented” and, initially, lobbied for a review of the garment rules in an open letter to the sport's governing body, FINA (the Fédération Internationale de Natation). Another maker, TYR Sport, has launched another type of suit altogether. It is suing Speedo's parent company, Warnaco Swimwear, Mr Schubert (for more or less insisting that members of his team wear the LZR) and others on antitrust grounds. The LZR is thus being referred to by some people as high-tech doping on a hanger.

Speedo's success is partly due to a subtle rule “clarification” made by FINA in April. It was this which confirmed that polyurethane areas can be incorporated into racing swimsuits. Other manufacturers complain it is unfair that a revision with sweeping implications took place a few months before the Olympics. Still, they are rushing to bring forward rival products. On June 4th FINA approved new suits by Arena, Adidas and Mizuno, so Speedo's technological lead may not last. In technology as in sport, records are simply there to be broken.

Economist.com BOOKS & ARTS

Walking in Palestine

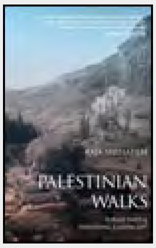
Lost land

Jun 12th 2008
From The Economist print edition

A sad and beautiful account of a much changed landscape

Magnum Photos

Palestinian Walks: Forays into a Vanishing Landscape
By Raja Shehadeh



Scribner; 200 pages; $15. Profile Books; £7.99

IT IS something of an irony that a land whose timeless beauty has survived basically unchanged since biblical times is being transformed by a people who base their claim to it on biblical history. Ugly, ever-expanding Israeli settlements sprawl on the West Bank's hilltops; great roads splice their way through its undulating, terraced hills; wildernesses have become national parks that are barred to Palestinians; and Arab villages that once blended organically into the landscape are little more than besieged ghettos.

Raja Shehadeh, a lawyer and writer living in Ramallah, used international and Israeli law to fight Israel's seizure of land belonging to Palestinians. He struggled tirelessly in the courts for years even while recognising that successive Israeli governments, determined to establish possession of vital parts of East Jerusalem and the West Bank, were not listening. In the end it was his own people who forced him to acknowledge defeat: the 1993 Oslo accords, he believes, gave the game away. He argues that in signing those accords Yasser Arafat put the principles of recognition and a possible two-state solution ahead of the need to stop the process of Israeli colonisation which was shredding one of those two states to ribbons. In his words, "the hollow language of peace" ran on as "our land was being transformed before our eyes."

Mr Shehadeh's delight at all times of stress was to ramble in the wild countryside. "Palestinian Walks", a short, superbly written book, recounts six such walks taken between 1978 and 2006. It was published last year in Britain (but only this month in the United States) and recently won the Orwell prize, an award for political writing. Mr Shehadeh describes the scenes around him—the colour of the wildflowers, the scent of herbs, the leaping grey gazelles, the rocks that "looked as though they had burst out of the ground, small islands perched on a sea of green"—but each walk leads us gently, through his conversation with companions, his reminiscences or his encounters on the way, to an apposite story or theme.

These vary from memories of a crusty old relative dancing round the dry-stone house he had just built with his new young wife his only assistant, through the frustration of those law-court battles, to a chance meeting with a young Israeli settler who parrots official nonsense but clearly loves the land, rescues Mr Shehadeh's hat from the water and invites him to share his excellent hashish hubble-bubble.

By the sixth walk, the rambles and scrambles are sharply circumscribed. Mr Shehadeh has to tread carefully, knowing that in many of his old haunts he risks being arrested by the police or shot by a suspicious settler. He mourns the turn of events by which Palestinians have come to move “in our own country surreptitiously, like unwanted strangers, constantly harassed, never feeling safe”. Readers who have been entranced by his wanderings, who have trembled with him on the ledges of rocky canyons (Mr Shehadeh suffers from vertigo), may find themselves echoing his lament for a lovely homeland now in the process of disappearing.

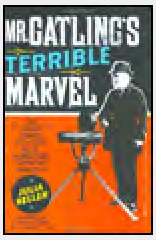
Palestinian Walks: Forays into a Vanishing Landscape.
By Raja Shehadeh.
Scribner; 200 pages; $15. Profile Books; £7.99

Machineguns

A little Gatling music

Jun 12th 2008
From The Economist print edition

Mr Gatling's Terrible Marvel: The Gun That Changed Everything and the Misunderstood Genius Who Invented It
By Julia Keller



Viking; 304 pages; $25.95 and £25.99

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COULD he really have been so naive? "It occurred to me", wrote Richard Gatling in 1877, "that if I could invent a machine—a gun—which could, by rapidity of fire, enable one man to do as much battle duty as a hundred, that it would, to a great extent, supersede the necessity of large armies." The invention that resulted, the first reliable machinegun, was better at killing than anything devised by man before.

Gatling's gun sent some 200 shots per minute out of six barrels, which were rotated by means of a hand crank. The idea was borrowed from an earlier Gatling machine, a seed hopper designed to speed up planting. It popped each seed into a chamber for distribution just as his gun placed bullets into the breach for firing. The Gatling gun changed the odds wherever it was used.

After a late entry into the American Civil War, delayed by suspicions of newfangled weapons among some senior soldiers, the Gatling gun was put to use at home and abroad. Police used it against strikers. Theodore Roosevelt was relieved to hear "Gatling music" in support while fighting the Spanish-American war.

The British, according to Julia Keller, used Gatlings to turn the map pink in Sudan, Egypt and northern Nigeria, as well as to mow down Zulu tribesmen. Winston Churchill, then a war correspondent reporting from Omdurman in Sudan, was shocked to see how the British Maxim guns, an improvement on Gatling's design, turned an army of some 50,000 Dervish warriors into "dirty bits of newspaper" strewn over the plain.

This worked only as long as the other side did not have machineguns. At the battle of Spion Kop in South Africa, the British came up against Boer soldiers with Maxims. The result was piles of bodies wearing British uniforms lying in a ditch. The pictures look like a scene from the Western Front 15 years later, and did as much as any change in sentiment towards the natives to dampen British enthusiasm for empire.

Gatling was rather good at selling his guns. They were bought by every army that could afford them, from China to Mexico. This rather undermines his humanitarian pose, which Ms Keller accepts at face value. Indeed, part of the problem with the book is that we do not seem to know very much about Gatling's internal life. "We know him, but we don't know him," the author says at the end, which is probably the sort of thing that a biographer should admit at the beginning of a book.

There are also some rather strange meanderings on world history, including a recurring analogy between the machinegun and the atom bomb that does not quite work. It is hard to avoid the impression that the author is straining to make a book out of a subject that does not really amount to one. Some points are repeated: Abraham Lincoln's patent for a device to haul barges in shallow waters and the quotation about Gatling's intentions both appear twice.

Even so, there are some fascinating details to be found among the often overwrought prose. Who knew that Samuel Colt, who became a famous maker of handguns, apparently had an early career travelling from town to town charging the curious for a lungful of laughing gas?

Gatling apparently never had a moment when he wished that he had invented something else—unlike Mikhail Kalashnikov, inventor of the AK-47, who once said that he would rather have developed something to make agriculture more efficient. Late in life, Gatling did divert his attention to steam-powered ploughs. But they did not work as well as his killing machine. The best epitaph for it, and for the refined versions it inspired, is probably the verse taken from the Book of Samuel and inscribed on the

monument to the Machine Gun Corps at London’s Hyde Park corner: “Saul hath slain his thousands, but David his tens of thousands.”

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Hedge funds

The Lo down

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THE basic idea behind efficient market theory is that it seems implausible that there are $20 notes lying on pavements waiting to be picked up. It is thus tough for investors to beat the stockmarket average. But the billion-dollar fortunes accumulated by hedge-fund managers (and the outsized fees they charge) imply that not just $20 notes but bulging wallets can be grabbed by those that are smart enough.

The belief that hedge-fund managers have the magic touch has prompted the industry to grow from just $39 billion of assets in 1990 to around $2 trillion today. But it has also prompted academics to examine exactly how hedge-fund managers are making their money, to question whether clients are getting the short end of the stick and to assess the impact of hedge-fund actions on the stability of financial markets as a whole.

Hedge Funds: An Analytic Perspective
By Andrew W. Lo

Princeton University Press; 364 pages; $45 and £26.95

Andrew Lo, a professor at the Massachusetts Institute of Technology, has been at the forefront of that process. His latest book, packed as it is with statistical tables and equations, will appear daunting to the casual reader. Nevertheless, anyone who is considering investing in hedge funds, or is involved in regulating the financial-services industry, should give it a go.

All those tables and equations are required because hedge-fund strategies are highly complex and, in the jargon, “non-linear”. In other words, all may appear to be going well, but then suddenly goes horribly wrong. The problem for investors is that strategies dubbed “picking up nickels in front of steamrollers” may deliver fat fees for the manager, only for the clients to pick up the bill when disaster hits.

This pattern of returns occurs because hedge-fund managers often invest in illiquid (hard-to-trade) assets. Since the prices of such assets rarely change, that can produce the illusion of smooth returns and make hedge-fund portfolios look less risky than they are. Mr Lo duly suggests a number of ways of assessing those dangers.

He also examines the market turmoil of August 2007, when some of the best- known hedge funds experienced unprecedented losses in the course of a couple of days. He says this provided the first piece of evidence that problems in one corner of the markets—in this case, subprime mortgages—can spill over into a completely unrelated area. Regulators should take note. Specifically, Mr Lo argues that the American watchdog, the Securities and Exchange Commission, should get more data on hedge-fund positions and should undertake an “air safety review” when individual funds go bust.

What about the thought that hedge funds undermine the idea of efficient markets? Instead, Mr Lo suggests an alternative concept: adaptive market theory. Under that system, he says, spare $20 notes do exist, maybe not on the high street, but in remote culs-de-sac. Hedge funds may be the first to spot them, but eventually a crowd gathers and the chance disappears.

This implies that a hedge-fund manager can build up a brilliant track record—but with no guarantee that he can keep it up. And that may explain why so many hedge-fund managers get rich, and why their clients are much less likely to do so.

Hedge Funds: An Analytic Perspective.
By Andrew W. Lo.
Princeton University Press; 364 pages; $45 and £26.95

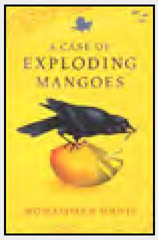
New fiction

Falling planes and poisoned swords

Jun 12th 2008
From The Economist print edition

Illustration by Daniel Pudles

A Case of Exploding Mangoes
By Mohammed Hanif



Knopf; 336 pages; $24. Jonathan Cape; £12.99

Buy it at
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Amazon.co.uk

THERE are many mysteries in Pakistan. The violent deaths of several political leaders, including General Zia ul Haq and Benazir Bhutto, have never been explained. One or two wars with India are also a puzzle. A history of military rule and a glorious culture of court intrigue are to blame. Yet, despite this rich subject-matter, and a privileged and voluble English-speaking class, Pakistan has produced little decent literature on its political dramas.

A London-based journalist, former air-force officer and, on this evidence, promising satirist, Mohammed Hanif has seized upon General Zia's demise. Ending a cruel 11-year rule, during which he did much to turn Pakistan towards Islamic fundamentalism, the general's plane fell out of the sky in 1988. In Pakistan, at least, it has always been assumed that either his army or America killed him—never mind that the American ambassador to Islamabad died with him.

Mr Hanif's hero is a trainee air-force officer, Ali Shigri, who is plotting to kill Zia with a poisoned sword at a national-day parade. He wants to avenge his father, a renegade war hero, who he believes was murdered by the army's Inter-Services Intelligence (ISI). The plot is foiled after Ali and his lover, a fellow recruit, are arrested and tortured. But then they are released: the ISI wants Zia dead too.

In his last days Zia is portrayed as a murderous buffoon: bullied by his wife, sobbing to Allah and suffering dreadfully from worms. A cast of almost-real characters from his rule—now synonymous with the American-funded and Pakistan-based jihad in Afghanistan—surrounds him, including OBL, a tall bearded Saudi construction magnate, who wants to be important.

All this is amusing, as is the tale's finale. Yet, for satire to bite, its characters have to be more complex or original than here. From its title, vaguely suggestive of Asia, to Osama bin Laden's walk-on role, Mr Hanif's book feels formulaic. Its absurdity, being unsurprising, seems a bit forced. But it is a good enough effort to keep an eye out for Mr Hanif's next book. He will have lots to write about.

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By Mohammed Hanif.
Knopf; 336 pages; $24. Jonathan Cape; £12.99

Philosophy and sociology

Bored by philosophy

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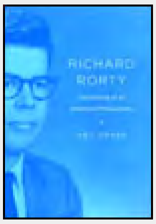
RICHARD RORTY, who died last year at 75, was one of the most talked-about thinkers in America. Every professional philosopher in the English-speaking world had to grapple with his magnum opus, "Philosophy and the Mirror of Nature", published in 1979. But the reason why he was a superstar is that it was not only philosophers who read him. Students and teachers in many other branches of the humanities fell under his spell. This wide appeal was partly due to his approachable style, trenchant polemics and breadth of learning. It also helped that he attacked philosophy as a puffed-up pretender with no monopoly on deep truths.

Richard Rorty: The Making of an American Philosopher
By Neil Gross



University of Chicago Press; 368 pages; $32.50 and £17

In fact, for Rorty there weren't really any deep truths at all. He saw himself as a pragmatist in the American tradition of William James and (especially) John Dewey. Pragmatists say that beliefs should be judged by their usefulness, and not by any supposed correspondence with an ultimate reality that lurks behind the landscape of everyday life. This sort of pragmatism—or so Rorty argued in "Philosophy and the Mirror of Nature"—demotes philosophy to just one form of edifying conversation among many.

In 1982, three years after the book was published, Rorty left the philosophy department of Princeton University to become a multidisciplinary professor of the humanities at the University of Virginia. In 1998 he packed his bags again to teach comparative literature at Stanford University in California.

This was not a particularly eventful life. Rorty's parents were left-wing anti-communist intellectuals. He was precocious and began studies at the University of Chicago at the age of 15. He was married, divorced and remarried. There were rows with departmental colleagues. He wrote a lot (in newspapers and magazines, as well as academic journals and books) and died of cancer. If Neil Gross, who is an American sociologist, had set out to write a traditional biography of Rorty, he would not have had a gripping tale to tell. Instead he has used Rorty as a case study in the sociological analysis of academe.

In theory, Rorty is a promising subject for such treatment. Here was a star of the dominant "analytical" movement in philosophy who, it seemed, suddenly turned on his colleagues and became an eclectic iconoclast.

Why did he do it? Unfortunately for anyone who is not a professional sociologist, Mr Gross is more interested in distinguishing subtly different ways of answering this question than he is in the question itself. And his writing seems almost designed to make pedestrian generalisations sound as if they are insights: "As thinkers move across the life course and are affiliated with different institutions, they may pick up from some of them identity elements that they integrate into their self-concept narratives."

Almost by accident, Mr Gross does shed some light on Rorty's development. He shows that his estrangement from his colleagues at Princeton was no volte-face but a natural evolution from his early studies in Chicago and graduate work at Yale. The two chapters about Rorty's parents may be useful raw material for scholars of the minor figures in pre-war intellectual life. Similarly, information about the minutiae of tenure decisions and rivalries in leading philosophy departments will be of interest to institutional historians.

But none of this is woven into an engaging narrative here. Those who agree with Rorty's critique of philosophy will be tempted to conclude from this volume that sociology is even worse.

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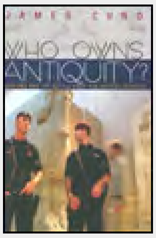
By Neil Gross.
University of Chicago Press; 368 pages; $32.50 and £17

Antiquities

The great heritage war

Jun 12th 2008
From The Economist print edition

Who Owns Antiquity? Museums and the Battle Over Our Ancient Heritage
By James Cuno



Princeton University Press; 256 pages; $24.95 and £14.95

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“THEY are all criminals, especially the Americans,” an eminent archaeologist declares. The evidence? They collect antiquities. This sort of remark is a typical attack in the long battle over who should or should not possess or trade in ancient objects. The combatants include governments, museums, art dealers and auction houses as well as archaeologists and private collectors.

James Cuno examines the underlying causes of this conflict, reporting on the wounds it is inflicting and proposing a route to a workable truce. He spotlights a single theatre of operations. Though the museums of his subtitle suggest that they are his focus, specialist institutions (showing ceramics, say, or Islamic art) are excluded. Encyclopedic museums—devoted to the exhibition and study of “representative examples of the world’s artistic legacy”—are what he concentrates on.

As such, the book is a report from the front-line. Since 2004 Mr Cuno has been director and president of the Art Institute of Chicago, an encyclopedic institution. And his name is currently being mentioned as a possible successor to Philippe de Montebello who retires in December as director of another, New York’s Metropolitan Museum of Art.

Although Mr Cuno clearly appreciates matters of aesthetic, historical and art-market importance, this is a political work. He takes the position that discussion of even the most clear-cut issues—looting and illegal trafficking, for instance, which all but the perpetrators agree must stop—has been shaped by the goals of the two opposing camps: nationalistic governments and “cosmopolitanists”.

Neil MacGregor, director of the British Museum—an example par excellence of institutional cosmopolitanism—defines his museum’s purpose as building a collection of diverse objects from around the world in order to reveal “not one perpetual truth” but rather “truth as a living, changing thing… constantly remade”. Antiquities gathered from across the globe, he argues, contribute to an understanding of our human past—wherever we happen to live.

Nations have a different goal. Italy, Greece, Egypt and China, for instance, declare that they have a right to ancient objects created on their land. It is their cultural patrimony, they say. Is it? Long-ago artefacts can be useful tools in establishing a national identity but is this sufficient reason to concede that these countries have the right to possess and control them? Mr Cuno, who explores these issues in detail, answers “not necessarily” to the first question and “no” to the second.

The author acknowledges the contribution to his thinking made by Kwame Anthony Appiah, a Princeton philosopher. Readers of Mr Appiah’s “Cosmopolitanism: Ethics in a World of Strangers” (published by Norton in 2006) will know how considerable this debt has been. In a chapter called “Whose culture is it, anyway?” Mr Appiah lays bare the illogicality of many cultural patrimony claims. Take, for example, Nigeria’s assertion that it has a right to possess Nok sculpture, made on its terrain 2,000 years ago. Mr Appiah points out that nothing is known about the people who made this sculpture, its purpose or its owners. About the only thing that can be said with certainty is that Nok sculpture was not made for Nigeria, a country that has yet to celebrate its centenary.

Mr Cuno recommends the reintroduction of partage as a way to end the conflict. Partage is the practice of archaeologists, their sponsors and the countries in which excavations take place of sharing out whatever is unearthed. Yet the reader senses he feels pessimistic. Understandably. An aura of political correctness has begun to hover over what he calls “nationalist retentionist cultural property laws” (Mr Cuno has an

unfortunate fondness for jargon).

Yet there may be cause for hope. Mr Cuno does not mention the internet until the very end of his book. Yet the online catalogues of encyclopedic museums are already visited by people from the Arctic Circle to the Horn of Africa. Although it is too soon to know how this will play out politically, it is evident that the internet fuels a hunger for more sharing and accessibility, and an impatience with being forced to settle for less. You might even say that the internet is cosmopolitanist by nature.

Who Owns Antiquity? Museums and the Battle Over Our Ancient Heritage.
By James Cuno.
Princeton University Press; 256 pages; $24.95 and £14.95

Jack Simplot

Jun 12th 2008
From The Economist print edition

JR Simplott Company

Jack Simplot, potato- and memory-chip tycoon, died on May 25th, aged 99

DOES the American Dream come with fries or hash browns? In Jack Simplot's version, it came with both. Starting out at 14 with little education and only $80 from his mother, Mr Simplot died a multi-billionaire. Much of his success he owed to the Russet Burbank that grows so well in Idaho's light volcanic soil, and Mr Spud, as he became known, never forgot this debt, nor rejected his roots: till the day he died his favourite restaurant was McDonald's, where he always ordered either french fries or hash browns.

Mr Simplot's was an all-American story, even involving a log cabin. That was the house built by his father, after the family moved to Idaho from Iowa in 1910. Dad, however, was stern and after a series of rows young Jack left home for the small town of Declo. The teachers in his boarding-house there were paid with IOUs that carried interest if held long enough. With money raised from rearing orphaned lambs, Jack bought these notes for 50 cents on the dollar and used them as collateral for a bank loan. That money bought him several hundred pigs, which he fattened with swill made from potato peelings and the meat of wild horses: “I shot 'em, jerked the hides off and cooked 'em myself,” he said. He sold the pigs for $7,800.

Next came farming and a half share in a machine that sorted potatoes. Unwilling to let Jack rent the machine out, his partner, who was “about half alcoholled up”, agreed to see outright ownership settled by the toss of a coin. Jack won. Mass sorting then began, followed by processing and drying, not just of potatoes but of other vegetables, too. A trip to California to collect a debt resulted in Mr Simplot coming back with an order for 500,000lb (227 tonnes) of dried onions; and onion powder, he said, was like gold dust.

By 1940 he had 30,000 acres (12,150 hectares) of land and was filling 10,000 freight wagons with potatoes a year. Once America was at war, every third portion of potatoes on the GIs' plates was supplied by Mr Simplot. He could take the credit when, in 1948, Idaho first put “World Famous Potatoes” on its car licence plates.

Eager to cut costs and to keep control, he became a great vertical integrator, owning much of the land on which he grew his produce and fertilising it with phosphate from his own mines. He even owned the forests that provided the wood for the boxes in which his veg was packed before he processed it. Any food he could not sell he fed to his cattle, and in time he would own the biggest cattle ranch in America.

With restless energy and a gambler's love of a new enterprise, he was always innovating. Not all his

ventures succeeded. An attempt to take large-scale farming to Germany was a failure, and other investments in Latin America and Europe flopped. But he looked only for a 51% success rate, and that he far exceeded. A hugely profitable breakthrough came in 1953, when one of his chemists perfected a technique for freezing chipped potatoes. By the late 1960s Mr Simplot was the biggest supplier of french fries to McDonald's. In 1980 a $1m investment gave him 40% of a start-up that became Micron Technology, which makes semiconductors for storing data in microchips and memory cards.

The odd felony

Mr Simplot's success had the traditional ingredients: hard work, thrift, enterprise, readiness to take risks and a shrewd ability to assess an opportunity. It also involved an occasional brush with the tax man. The authorities first accused him of tax dodging after the war. Charged with trying to manipulate potato futures, he paid $50,000 in fines in 1976, and he and his privately owned company both paid more fines for tax fraud in 1977.

In other respects, too, Mr Simplot departed from the usual heroic script. The patriot who flew a gigantic Stars and Stripes above his house thought religion was “hocus-pocus”. The lifelong teetotaller and anti-smoker was addicted to sleeping pills. The munificent donor to many good causes was ready to foreclose on a loan to his son. Indeed, the man who said he put his family above all else was a distant father to both his eldest boys, whom he sent away to school. He made more time, though, for his adored grandchildren.

He had critics, too. Environmentalists in particular were horrified at his company's hostility to land-use and clean-air laws. Mr Simplot himself, an avowed lover of skiing, duck shooting and the great outdoors, was attacked in the 1970s for his support for new coal-fired electricity plants along the Snake river and for a scheme to generate hydro-power by diverting water from another river into a vast underground tube. Free-traders took him to task for his readiness to lobby President Ronald Reagan to put a $300m tariff on imported computer chips.

Other traits earned a certain admiration. Mr Simplot was unstuffy: he often answered the telephone himself and his number was never ex-directory. He was frugal to the point of stinginess, driving a scruffy Lincoln Town Car for six or seven years before buying a new one, and he did not like paying to have the brakes fixed. Even his hostility to “goddamn parking spaces for cripples” may not have done him any harm. In potato country, the American Dream does not have much room for political correctness.

Economist.com
MARKETS & DATA
WEEKLY INDICATORS

Overview

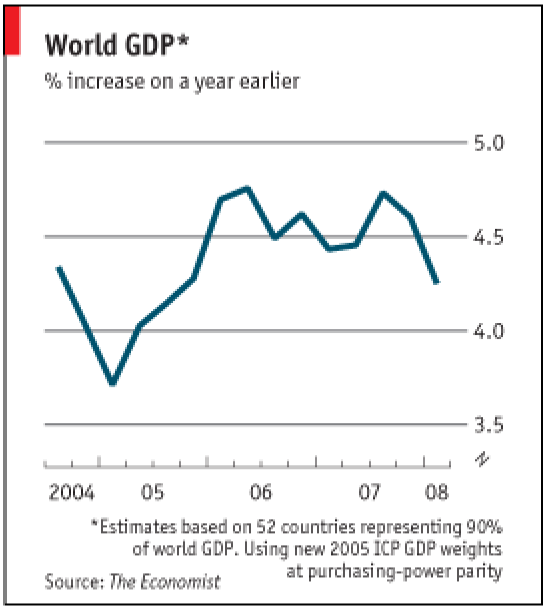
Jun 12th 2008
From The Economist print edition

The **oil price** gyrated. On June 6th it reached a new high of $139 a barrel, after a record one-day rise. On June 11th it closed at $136.

The surge in the oil price followed figures showing that **America's unemployment rate** had risen from 5.0% in April to 5.5% in May, the biggest monthly rise for 22 years.

Inflation fears and hawkish rhetoric from central bankers prompted rises in **interest-rate expectations** in the United States, euro area and Britain. The Bank of Canada surprised the markets by keeping its policy rate unchanged at 3.0%. The Reserve Bank of India raised rates, by 25 basis points, to 8%.

Britain's labour market is weakening. Unemployment increased by 38,000 in the three months to April compared with the previous quarter; the jobless rate edged up to 5.3%.



Output, prices and jobs

Jun 12th 2008
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	+2.5 Q1	+0.9	+1.2	+1.5	+0.2 Apr	+3.9 Apr	+2.6	+3.8	5.5 May
Japan	+1.3 Q1	+4.0	+1.3	+1.4	+1.8 Apr	+0.8 Apr	nil	+1.1	4.0 Apr
China	+10.6 Q1	na	+9.8	+9.0	+15.7 Apr	+8.5 Apr	+3.0	+6.5	9.5 2007
Britain	+2.5 Q1	+1.6	+1.7	+1.4	+0.2 Apr	+3.0 Apr§	+2.8	+3.0	5.3 Apr††
Canada	+1.7 Q1	−0.3	+1.4	+2.1	−4.8 Mar	+1.7 Apr	+2.2	+1.8	6.1 Apr
Euro area	+2.2 Q1	+3.2	+1.7	+1.5	+2.0 Mar	+3.6 May	+1.9	+3.1	7.1 Apr
Austria	+3.5 Q1	+3.2	+2.4	+2.2	−1.1 Mar	+3.3 Apr	+1.8	+2.6	4.2 Apr
Belgium	+2.1 Q1	+1.6	+1.7	+1.7	+5.7 Feb	+5.2 May	+1.3	+3.0	10.3 Apr‡‡
France	+2.2 Q1	+2.6	+1.7	+1.5	+3.2 Apr	+3.3 May	+1.1	+2.9	7.2 Q1§§
Germany	+1.8 Q1	+6.1	+1.9	+1.6	+4.8 Apr	+3.0 May	+2.1	+2.7	7.9 May
Greece	+3.6 Q1	+4.5	+2.8	+3.0	+2.0 Apr	+4.4 Apr	+2.5	+3.9	8.0 Feb
Italy	+0.3 Q1	+1.9	+0.6	+1.1	+2.0 Apr	+3.6 May	+1.5	+2.9	6.0 Q4
Netherlands	+3.1 Q1	+1.0	+2.6	+2.0	+0.4 Apr	+2.3 May	+1.8	+2.3	4.0 Apr††
Spain	+2.7 Q1	+1.2	+2.1	+1.8	+11.3 Apr	+4.6 May	+2.3	+3.8	9.6 Apr
Czech Republic	+5.3 Q1	+3.6	+4.7	+5.4	+12.2 Apr	+6.8 May	+2.4	+6.3	5.0 May
Denmark	+1.9 Q4	+1.2	+1.5	+1.7	+7.8 Apr	+3.4 May	+1.8	+3.0	1.8 Apr
Hungary	+1.7 Q1	+1.3	+2.3	+3.4	+6.7 Apr	+7.0 May	+8.5	+5.9	7.7 Apr††
Norway	+0.9 Q1	+0.8	+2.7	+2.4	−4.4 Apr	+3.1 May	+0.3	+3.4	2.4 Mar***
Poland	+6.1 Q1	na	+5.1	+4.3	+14.9 Apr	+4.0 Apr	+2.3	+4.2	10.5 Apr‡‡
Russia	+8.0 Q1	na	+7.2	+6.4	+9.2 Apr	+15.1 May	+7.8	+13.5	6.6 Apr‡‡
Sweden	+2.2 Q1	+1.6	+2.3	+2.1	+0.8 Mar	+4.0 May	+1.7	+3.0	5.9 May‡‡
Switzerland	+3.1 Q1	+1.3	+2.1	+1.7	+9.1 Q4	+2.9 May	+0.5	+2.0	2.4 May
Turkey	+3.4 Q4	na	+3.2	+4.1	+6.3 Apr	+10.7 May	+9.2	+10.2	11.6 Q1‡‡
Australia	+3.6 Q1	+2.5	+2.9	+3.0	+0.1 Q4	+4.2 Q1	+2.4	+3.6	4.3 May
Hong Kong	+6.8 Q1	+7.4	+4.6	+4.5	−0.3 Q4	+5.4 Apr	+1.3	+5.3	3.3 Apr††
India	+8.8 Q1	na	+7.6	+7.1	+7.0 Apr	+7.8 Apr	+6.7	+6.0	7.2 2007
Indonesia	+6.3 Q1	na	+5.7	+5.9	+1.4 Mar	+10.4 May	+6.0	+9.0	9.1 Dec
Malaysia	+7.1 Q1	na	+5.8	+5.8	+4.3 Apr	+3.0 Apr	+1.5	+2.8	3.0 Q4
Pakistan	+7.0 2007**	na	+4.6	+5.1	+3.2 Mar	+19.3 May	+7.4	+12.1	6.2 2006
Singapore	+6.7 Q1	+14.6	+4.5	+5.0	−5.7 Apr	+7.5 Apr	+0.6	+4.3	2.0 Q1
South Korea	+5.8 Q1	+3.3	+4.5	+4.3	+10.5 Apr	+4.9 May	+2.3	+2.9	3.2 Apr
Taiwan	+6.1 Q1	na	+4.3	+4.4	+9.6 Apr	+3.7 May	nil	+2.6	3.9 Apr
Thailand	+6.0 Q1	+5.9	+4.8	+4.6	+10.1 Apr	+7.6 May	+1.9	+6.2	1.5 Feb
Argentina	+9.1 Q4	+8.0	+6.3	+4.5	+8.6 Apr	+8.9 Apr	+8.9	+10.3	8.4 Q1‡‡
Brazil	+5.8 Q1	+2.9	+4.6	+3.8	+1.2 Mar	+5.0 Apr	+3.0	+5.2	8.5 Apr‡‡
Chile	+4.0 Q4	+3.7	+3.8	+4.2	+4.4 Apr	+8.3 Apr	+2.5	+6.7	7.6 Apr††‡‡
Colombia	+8.1 Q4	+6.8	+5.0	+4.5	−9.4 Mar	+6.4 May	+6.2	+6.0	11.1 Mar‡‡
Mexico	+2.6 Q1	+2.1	+2.1	+2.5	−4.9 Mar	+4.9 May	+3.9	+4.7	3.6 Apr‡‡
Venezuela	+4.8 Q1	na	+6.1	+4.9	+12.2 Feb	+29.3 Apr	+19.4	+29.6	8.2 Q1‡‡
Egypt	+6.9 Q1	na	+6.9	+6.8	+7.5 2007**	+19.7 May	+10.0	+15.5	9.0 Q4‡‡
Israel	+5.2 Q1	+5.4	+3.9	+3.6	+9.3 Mar	+4.7 Apr	−1.3	+4.2	6.3 Q1
Saudi Arabia	+3.5 2007	na	+6.0	+5.6	na	+10.5 Apr	+2.9	+8.5	na
South Africa	+4.0 Q1	+2.1	+3.9	+4.4	+9.8 Apr	+11.1 Apr	+7.0	+8.2	23.0 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	+0.1 Q1	+7.8	+2.8	+3.7	−0.2 Apr	+11.3 May	+5.7	+9.3	5.5 Mar
Finland	+3.1 Q1	+2.8	+2.7	+2.4	+7.8 Apr	+3.5 Apr	+2.6	+3.0	5.8 Apr
Iceland	+4.6 Q4	+1.4	+1.1	+1.7	+0.4 2007	+12.3 May	+4.7	+10.0	1.0 Apr‡‡
Ireland	+3.5 Q4	−3.3	+2.4	+2.2	+7.0 Mar	+4.3 Apr	+5.1	+3.2	5.4 May
Latvia	+3.3 Q1	na	+2.4	+3.0	−5.5 Mar	+17.9 May	+8.2	+13.2	4.9 Mar
Lithuania	+6.9 Q1	−0.8	+5.6	+5.0	na	+12.0 May	+4.8	+10.2	4.5 Apr‡‡
Luxembourg	+3.8 Q4	+7.4	+3.9	+3.6	+1.6 Mar	+3.5 Apr	+2.1	+3.4	4.2 Mar‡‡
New Zealand	+2.8 Q4	+3.1	+1.4	+2.3	+4.2 Q4	+3.4 Q1	+2.5	+3.3	3.6 Q1
Peru	+5.6 Mar	na	+7.5	+6.4	+6.4 Mar	+5.4 May	+0.9	+4.8	8.5 Apr‡‡
Philippines	nil	nil	+5.6	+5.7	+8.6 Feb	+9.6 May	+2.4	+6.8	7.4 Q1‡‡
Portugal	+0.9 Q1	−1.0	+1.5	+1.6	−5.2 Mar	+2.5 Apr	+2.7	+2.4	7.6 Q1‡‡
Slovakia	+8.7 Q1	na	+7.5	+5.7	+9.7 Apr	+4.2 Apr	+2.7	+3.5	7.4 Apr‡‡
Slovenia	+5.4 Q1	na	+4.5	+4.0	+6.9 Apr	+6.4 May	+2.9	+5.4	6.9 Mar‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate 4.2% in Apr. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

The Economist commodity-price index

Jun 12th 2008
From The Economist print edition

The Economist commodity-price index

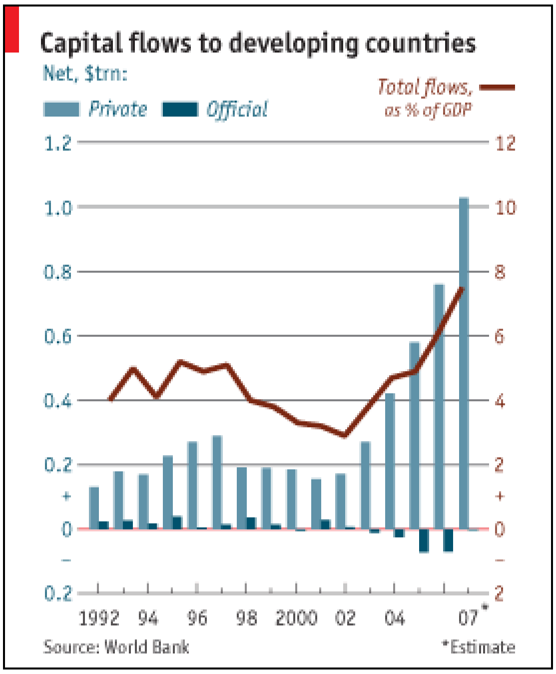
2000=100

	Jun 3rd	Jun 10th*	% change on one month	% change on one year
Dollar index				
All items	250.6	256.7	−0.4	+27.3
Food	252.1	262.4	+2.2	+54.9
Industrials				
All	248.6	249.1	−3.8	+2.4
Nfa†	199.0	201.3	+1.8	+23.8
Metals	275.8	275.4	−5.8	−4.1
Sterling index				
All items	193.3	199.3	−0.7	+28.7
Euro index				
All items	149.9	153.3	−0.4	+9.5
Gold				
$ per oz	881.50	871.75	+0.4	+34.4
West Texas Intermediate				
$ per barrel	124.33	131.69	+4.6	+101.7

*Provisional †Non-food agriculturals.

Capital flows to developing countries

Jun 12th 2008
From The Economist print edition



Net private-capital flows to developing countries reached a record $1.03 trillion in 2007, a big jump from the $760 billion recorded in 2006. However, much of the increase reflected the depreciation of the dollar against most other currencies. As a share of developing countries' GDP, net inflows went up from 6.7% in 2006 to 7.5% last year, a much more modest rise. After falling in 2000 and 2001, the influx of private capital recovered a little in 2002 and has since grown by leaps and bounds. The World Bank expects inflows to fall in 2008 and 2009, but if the global economic slowdown is moderate and credit conditions do not get worse, they could still be as high as $850 billion next year.

Trade, exchange rates, budget balances and interest rates

Jun 12th 2008
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ Jun 11th	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−831.2 Apr	−738.6 Q4	−4.9	–	–	−2.4	2.14	4.07
Japan	+100.3 Apr	+213.5 Apr	+4.3	107	122	−2.9	0.75	1.84
China	+254.2 May	+371.8 2007	+9.8	6.92	7.64	0.3	4.48	4.48
Britain	−184.5 Apr	−115.4 Q4	−3.9	0.51	0.51	−3.2	5.93	5.12
Canada	+45.6 Apr	+14.5 Q1	+0.2	1.02	1.07	0.4	2.76	3.90
Euro area	+14.1 Mar	+5.3 Mar	−0.1	0.64	0.75	−0.9	4.96	4.52
Austria	+0.9 Mar	+12.2 Q4	+3.0	0.64	0.75	−0.4	4.96	4.76
Belgium	+14.3 Feb	+2.7 Dec	+2.1	0.64	0.75	−0.3	5.03	4.86
France	−61.6 Apr	−39.9 Apr	−1.6	0.64	0.75	−2.9	4.96	4.75
Germany	+278.7 Apr	+269.8 Apr	+6.1	0.64	0.75	1.1	4.96	4.55
Greece	−60.2 Mar	−45.2 Mar	−13.7	0.64	0.75	−2.6	4.96	5.10
Italy	−12.9 Mar	−57.0 Mar	−2.5	0.64	0.75	−2.6	4.96	5.13
Netherlands	+57.4 Mar	+50.7 Q4	+6.0	0.64	0.75	0.7	4.96	4.77
Spain	−147.1 Mar	−159.3 Mar	−9.1	0.64	0.75	−0.7	4.96	4.83
Czech Republic	+4.7 Apr	−4.0 Mar	−2.9	15.7	21.5	−2.5	4.21	5.14
Denmark	+4.2 Apr	+3.5 Apr	+1.0	4.80	5.60	3.6	5.60	4.85
Hungary	+0.5 Apr	−6.9 Q4	−5.9	159	190	−4.2	8.94	9.00
Norway	+66.9 Apr	+68.8 Q1	+17.5	5.15	6.08	17.8	6.40	4.88
Poland	−14.7 Mar	−18.4 Mar	−3.8	2.18	2.87	−2.1	6.58	6.42
Russia	+157.9 Apr	+92.4 Q1	+5.2	23.7	26.0	3.5	10.75	6.50
Sweden	+18.9 Apr	+40.4 Q1	+7.2	6.03	7.07	2.1	4.10	4.38
Switzerland	+13.6 Apr	+71.1 Q4	+14.8	1.03	1.24	0.9	2.88	3.38
Turkey	−68.6 Apr	−40.4 Mar	−6.5	1.26	1.34	−2.9	19.31	6.96‡
Australia	−22.5 Apr	−61.4 Q1	−5.9	1.06	1.19	1.6	7.90	6.67
Hong Kong	−24.4 Apr	+28.0 Q4	+9.1	7.81	7.81	2.9	2.15	3.46
India	−80.5 Apr	−12.8 Q4	−2.4	42.9	41.0	−3.2	7.54	8.63
Indonesia	+38.1 Apr	+10.9 Q1	+2.3	9,305	9,083	−2.1	8.98	7.28‡
Malaysia	+33.4 Apr	+28.9 Q4	+12.5	3.27	3.47	−3.1	3.65	4.46‡
Pakistan	−19.8 May	−8.3 Q4	−8.8	67.1	60.6	−4.7	12.66	11.25‡
Singapore	+30.5 Apr	+35.8 Q1	+24.4	1.37	1.54	1.0	1.44	3.41
South Korea	+5.4 May	+2.9 Apr	+0.3	1,030	931	0.5	5.35	5.84
Taiwan	+13.9 May	+32.2 Q1	+5.4	30.4	33.0	−1.8	2.70	2.70
Thailand	+6.3 Apr	+11.7 Apr	+3.2	33.1	34.6	−3.1	3.55	5.33
Argentina	+11.7 Apr	+7.2 Q4	+2.4	3.06	3.07	1.8	16.88	na
Brazil	+31.9 May	−14.7 Apr	−1.1	1.65	1.94	−1.9	12.16	6.16‡
Chile	+19.1 May	+4.3 Q1	+2.5	486	529	7.0	6.60	4.76‡
Colombia	+0.4 Mar	−5.9 Q4	−3.4	1,704	1,938	−1.6	9.21	5.76‡
Mexico	−9.6 Apr	−4.8 Q1	−1.2	10.4	11.0	nil	7.47	8.68
Venezuela	+30.1 Q1	+26.7 Q1	+7.0	3.30	4.23§	2.1	17.69	6.55‡
Egypt	−20.5 Q4	+0.5 Q4	+0.2	5.36	5.70	−7.1	9.47	4.70‡
Israel	−12.4 Apr	+5.0 Q4	+0.2	3.40	4.18	−1.3	3.39	5.53
Saudi Arabia	+150.8 2007	+95.0 2007	+38.4	3.75	3.75	26.2	3.06	na
South Africa	−11.1 Apr	−20.6 Q4	−8.0	8.03	7.24	0.4	12.58	10.33
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−4.4 Mar	−3.4 Mar	−12.7	10.1	11.8	0.2	6.47	na
Finland	+12.3 Mar	+12.5 Mar	+3.9	0.64	0.75	4.7	4.80	4.73
Iceland	−1.4 May	−3.5 Q1	−12.2	77.6	63.4	0.7	15.82	na
Ireland	+36.7 Mar	−12.7 Q4	−4.0	0.64	0.75	−0.9	4.96	4.88
Latvia	−7.3 Apr	−6.3 Mar	−13.2	0.45	0.52	nil	5.52	na
Lithuania	−7.8 Apr	−5.8 Mar	−11.5	2.22	2.60	−0.7	5.47	na
Luxembourg	−6.3 Mar	+3.9 Q4	na	0.64	0.75	1.5	4.96	na
New Zealand	−3.5 Apr	−10.2 Q4	−7.0	1.32	1.33	1.9	7.25	6.47
Peru	+8.3 Mar	+0.8 Q1	+0.4	2.88	3.17	1.6	5.50	na
Philippines	−7.3 Mar	+6.4 Dec	+4.1	44.5	46.7	−0.5	6.75	na
Portugal	−29.3 Mar	−24.5 Mar	−8.3	0.64	0.75	−2.5	4.96	4.97
Slovakia	−1.1 Apr	−4.2 Feb	−3.3	19.5	25.8	−2.1	4.11	5.04
Slovenia	−3.4 Apr	−2.8 Mar	−4.0	0.64	0.75	−0.2	na	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

Markets

Jun 12th 2008
From The Economist print edition

Markets

	Index Jun 11th	% change on one week	% change on Dec 31st 2007 in local currency	% change on Dec 31st 2007 in $ terms
United States (DJIA)	12,083.8	-2.5	-8.9	-8.9
United States (S&P 500)	1,335.5	-3.0	-9.0	-9.0
United States (NAScomp)	2,394.0	-4.4	-9.7	-9.7
Japan (Nikkei 225)	14,183.5	-1.7	-7.3	-3.1
Japan (Topix)	1,390.0	-2.8	-5.8	-1.5
China (SSEA)	3,172.4	-10.3	-42.5	-39.3
China (SSEB, $ terms)	227.7	-6.1	-41.0	-37.8
Britain (FTSE 100)	5,723.3	-4.1	-11.4	-12.6
Canada (S&P TSX)	14,716.5	+0.2	+6.4	+3.3
Euro area (FTSE Euro 100)	1,110.1	-5.2	-19.3	-14.2
Euro area (DJ STOXX 50)	3,509.4	-5.1	-20.2	-15.2
Austria (ATX)	4,097.8	-4.9	-9.2	-3.5
Belgium (Bel 20)	3,546.9	-4.5	-14.1	-8.7
France (CAC 40)	4,660.9	-5.2	-17.0	-11.8
Germany (DAX)*	6,650.3	-4.5	-17.6	-12.4
Greece (Athex Comp)	3,877.6	-5.7	-25.1	-20.4
Italy (S&P/MIB)	30,728.0	-5.5	-20.3	-15.3
Netherlands (AEX)	456.3	-4.6	-11.5	-6.0
Spain (Madrid SE)	1,356.5	-5.5	-17.4	-12.2
Czech Republic (PX)	1,585.4	-3.8	-12.7	+1.3
Denmark (OMXCB)	408.1	-4.1	-9.1	-3.4
Hungary (BUX)	21,283.5	-4.2	-18.9	-12.0
Norway (OSEAX)	553.0	-1.6	-3.0	+2.3
Poland (WIG)	42,968.1	-6.4	-22.8	-12.8
Russia (RTS, $ terms)	2,356.7	+0.1	-0.8	+2.9
Sweden (Aff.Gen)	293.2	-5.0	-13.9	-7.6
Switzerland (SMI)	7,167.3	-4.6	-15.5	-7.6
Turkey (ISE)	38,238.4	-4.0	-31.1	-35.9
Australia (All Ord.)	5,561.9	-2.4	-13.4	-6.2
Hong Kong (Hang Seng)	23,327.6	-3.3	-16.1	-16.3
India (BSE)	15,185.3	-2.1	-25.1	-31.2
Indonesia (JSX)	2,374.8	+0.5	-13.5	-12.7
Malaysia (KLSE)	1,229.3	-1.9	-14.9	-14.0
Pakistan (KSE)	13,016.4	-0.6	-7.5	-15.1
Singapore (STI)	3,046.8	-2.8	-12.1	-7.8
South Korea (KOSPI)	1,781.7	-2.8	-6.1	-14.6
Taiwan (TWI)	8,345.6	-3.3	-1.9	+4.8
Thailand (SET)	791.7	-2.1	-7.7	-6.2
Argentina (MERV)	2,072.1	-3.2	-3.7	-0.9
Brazil (BVSP)	66,794.0	-2.7	+4.6	+13.1
Chile (IGPA)	14,302.1	-0.2	+1.6	+4.1
Colombia (IGBC)	9,712.0	-2.9	-9.2	+7.5
Mexico (IPC)	30,446.2	-3.2	+3.1	+7.8
Venezuela (IBC)	36,720.6	+3.9	-3.1	-37.0
Egypt (Case 30)	10,638.7	-3.9	+1.6	+4.7
Israel (TA-100)	1,016.7	-0.9	-11.9	-0.3
Saudi Arabia (Tadawul)	9,688.5	+2.1	+22.1	+22.1
South Africa (JSE AS)	30,640.0	-2.7	+5.8	-9.9
Europe (FTSEurofirst 300)	1,249.5	-4.8	-17.1	-11.9
World, dev'd (MSCI)	1,453.2	-3.4	-8.5	-8.5
Emerging markets (MSCI)	1,131.4	-3.6	-9.2	-9.2
World, all (MSCI)	368.5	-3.4	-8.6	-8.6
World bonds (Citigroup)	755.5	-1.1	+3.4	+3.4
EMBI+ (JPMorgan)	440.2	-0.7	+1.5	+1.5
Hedge funds (HFRX)	1,322.9	-0.4	-0.5	-0.5
Volatility, US (VIX)	27.3	20.8	22.5	(levels)
CDSs, Eur (iTRAXX)†	92.6	+8.3	+83.0	+94.4
CDSs, N Am (CDX)†	123.0	+5.2	+40.5	+40.5
Carbon trading (EU ETS) €	27.3	+4.5	+22.9	+30.6

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

Leading centres of commerce

Jun 12th 2008
From The Economist print edition

London and New York remain the top two centres for global commerce, according to an index of 75 cities compiled by MasterCard. An expert panel rated the cities according to how they perform in seven main areas, such as ease of doing business, “livability”, and the legal and political framework. These are assigned different weights—for example, ease of doing business accounts for 20% of the index, livability for 10%—and performance in each area is worked out from an array of indicators. London came top because of its global connectedness and strengths in finance and knowledge creation, which more than made up for a weaker score on livability, where it was ranked 24th.